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BASICS TRACK: REGISTRATION & DISCLOSURE

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Table of Contents

	<u>Page</u>
I. National Pre-Sale Franchise Regulation	1
A. Federal Trade Commission’s Franchise Rule	1
1. The History and Intended Purpose of the Franchise Rule	1
2. What is a Franchise and When is Compliance with the FTC Franchise Rule Required	2
3. Disclosure Obligations	3
B. State Regulation	6
II. Franchise Disclosure Document	7
A. Drafting Tips and Tools	7
B. Federal Disclosure Requirements	9
1. Federal Cover Page	9
2. Item 1: The Franchisor and Any Parents, Predecessors and Affiliates	10
3. Item 2: Business Experience	10
4. Item 3: Litigation	11
5. Item 4: Bankruptcy	11
6. Item 5: Initial Fees	11
7. Item 6: Other Fees	12
8. Item 7: Estimated Initial Investment	12
9. Item 8: Restrictions on Sources of Products and Services	13
10. Item 9: Franchisee’s Obligations	14
11. Item 10: Financing	14
12. Item 11: Franchisor’s Assistance, Advertising, Computer Systems and Training	14
13. Item 12: Territory	16
14. Item 13: Trademarks	17
15. Item 14: Patents, Copyrights and Proprietary Information	18
16. Item 15: Obligation to Participate in the Actual Operation of the Franchised Business	18
17. Item 16: Restrictions on What the Franchisee May Sell	19
18. Item 17: Renewal, Termination, Transfer and Dispute Resolution	19
19. Item 18: Public Figures	19
20. Item 19: Financial Performance Representations	20
21. Item 20: Outlets and Franchisee Information	23
22. Item 21: Financial Statements	24
23. Item 22: Contracts	24
24. Item 23: Receipts	25
C. State-Specific Disclosure Requirements	25
1. Examples of Additional State-Specific Disclosures	26

2.	State Cover Page and Risk Factors	27
3.	State Addenda.....	28
4.	State-Specific Timing Requirements	28
III.	Securing State Franchise Registration.....	29
A.	State Registration Filing Requirements.....	29
B.	State Examiner Review Process and Comment Letters.....	29
C.	Strategies for Managing the Registration Process	30
IV.	Franchise Amendment and Renewal Requirements.....	31
A.	When is an Amendment Necessary	32
1.	Federal Requirements.....	32
2.	State Requirements.....	32
B.	Annual Renewal Requirements.....	33
1.	Federal Requirements.....	33
2.	State Requirements.....	33
C.	Permitted Activities While Renewal or Amendment Applications are Pending.....	34
V.	Navigating Franchise Exemptions	34
A.	FTC Franchise Rule Exemptions	35
1.	Fractional Franchise Exemption	35
2.	Minimal Franchise Fee Exemption	36
3.	Large Franchisee Exemption.....	36
4.	Large Investment Exemption.....	37
5.	Other Exemptions.....	37
B.	State Exemptions	38
1.	Large Franchisor Exemption	38
2.	Large Franchisee Exemption.....	38
3.	Fractional Franchise Exemption	39
4.	Other Exemptions.....	39
VI.	Additional Filing Requirements Beyond the FDD.....	39
A.	Advertising Registration Requirements.....	39
B.	Franchise Seller / Broker Requirements	40
VII.	Conclusion	41

Exhibits

- Exhibit A - Sample Item 9 Table
- Exhibit B – Sample Item 10 Table
- Exhibit C – Sample Item 17 Chart
- Exhibit D – Sample State Risk Factors
- Exhibit E – Sample State FDD Addenda
- Exhibit F – Initial State Registration Requirements
- Exhibit G – Federal & State Franchise Exemptions
- Exhibit H – Advertising Registration Requirements

I. National Pre-Sale Franchise Regulation

Franchising is an effective means of brand expansion. Franchising also provides motivated investors with the tools necessary to establish and operate their own businesses, including the right to use a trademark and access to a business operating system. However, a complex patchwork of both federal and state laws governs the offer and sale of franchises in the United States, and compliance with these laws is essential to the development of a franchise system. This paper provides a broad overview of the regulatory framework governing the offer and sale of franchises in the United States, including disclosure and registration requirements.¹

A. Federal Trade Commission's Franchise Rule

1. The History and Intended Purpose of the Franchise Rule

The Federal Trade Commission's ("FTC's") Rule on Franchising (the "Franchise Rule"), codified at 16 CFR Part 436, was enacted in 1979 after a lengthy rule-making process.² The catalyst for the enactment of the Franchise Rule was a boom in the franchise industry after World War II and alleged instances of fraud and misrepresentation in connection with the offer and sale of franchises during that time.³ The Franchise Rule required pre-sale disclosure and prohibited certain practices which the FTC deemed unfair or deceptive in nature.

The purpose of the pre-sale disclosure requirement was to provide each franchisee with "at least the minimum information needed to make an informed decision whether to enter into the franchise relationship."⁴ Significantly, in enacting the Franchise Rule, the FTC chose not to regulate the substantive terms of the franchise relationship "on the theory that informed investors can determine for themselves whether a particular deal is in their best interest."⁵ The FTC also chose not to create a private right of action allowing investors to bring suit seeking damages or other redress based on alleged violations of the Franchise Rule.

In 2007, the Franchise Rule was amended (the "Amended Rule") to, among other things, clarify points of ambiguity identified by practitioners after nearly 30 years of working under the original Franchise Rule, align the Franchise Rule with state franchise

¹ No summary, however thorough, is a substitute for a detailed review of applicable laws and regulations in connection with the representation of a client.

² 16 C.F.R. §436.1 (1978) Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures.

³ William L. Killion, *The Modern Myth of the Vulnerable Franchisee: The Case for a More Balanced View of the Franchisor-Franchisee Relationship*, Vol. 28, Franchise L.J., 23-33 (Summer 2008). Mr. Killion provides a thorough "history lesson" on franchising and argues that "after nearly forty years of franchise presale disclosure and relationship regulations, ever-increasing competition among franchisors for franchisees, and a marked change in the sophistication of franchisees, franchising should not continue to suffer a hangover in the twenty-first century from abuses that may or may not have been rampant decades earlier. The wrong that the legislators set out to correct beginning in 1970 has now been righted." *Id.* at 24.

⁴ Statement of Basis and Purpose, 43 FR 59621 (Dec. 21, 1978) (the "Original SBP").

⁵ Statement of Basis and Purpose 16 C.F.R. 15444, 15445 (March 30, 2007) (the "Amended SBP").

disclosure laws (described below), and take into account advances in technology (such as electronic disclosure). The Amended Rule also sought to address franchise relationship issues which the FTC determined were prevalent sources of franchisee complaints. For example, the Amended Rule requires the disclosure of all franchisor-initiated litigation against franchisees, broadens the disclosure requirements relating to territorial rights, requires the disclosure of confidentiality provisions in franchise agreements, and requires the disclosure of trademark-specific franchisee associations. Like the original Franchise Rule, the Amended Rule also did not create a private right of action.

In short, the rules established by the FTC aim to provide franchisees with sufficient information to make informed purchasing decisions, and to protect franchisors and franchisee by mandating disclosures that set the parties' expectations. All references to federal regulations in this paper relate to the Amended Rule unless specifically noted otherwise.

2. What is a Franchise and When is Compliance with the FTC Franchise Rule Required

The Amended Rule defines a franchise as any continuing commercial relationship or arrangement in which the franchisor: (1) grants to the franchisee the right to use the franchisor's trademark or other commercial symbol; (2) retains the right to exert significant control or agrees to provide significant assistance to the franchisee with respect to the operation of the business (e.g., specifying a method for doing business under the mark); and (3) charges a fee greater than \$570 during the first six months of operations.⁶ Once these criteria are established, whether by contract or by practice, the terms of the Amended Rule apply. Further, the parties cannot avoid the applicability of the Amended Rule by referring to the relationship by another name or specifically disclaiming the applicability of the Amended Rule in the agreement governing the relationship.⁷

While the Amended Rule's definition of a franchise relationship is broad, it does not govern all arrangements involving a trademark license and/or the promise of significant control or assistance by the seller. For example, the Amended Rule specifically exempts single trademark licenses,⁸ franchise relationships governed by the Petroleum Marketing Practices Act, and business opportunities.⁹ Exemptions to the Amended Rule are discussed in Section V below.

⁶ 16 C.F.R. §436.1(h). The Amended Rule originally set the minimum fee requirement at \$500. The Amended Rule, however, requires the Federal Trade Commission (the "Commission") to adjust the minimum fee threshold every four years to account for inflation. The Commission adjusted the minimum fee threshold to \$570 effective July 1, 2016. See, "FTC Adjusts Monetary Thresholds for Three Exemptions in Franchise Rule," (May 16, 2016), <https://www.ftc.gov/news-events/press-releases/2016/05/ftc-adjusts-monetary-thresholds-three-exemptions-franchise-rule>.

⁷ See, 16 C.F.R. §436.9(h). See also, William L. Killion and Sarah J. Yatchak, *But it Doesn't Walk or Talk Like a Duck: The Perils of the Hidden Franchise*, Bus. Law Today Vol. 17, No.1 (Sept. / Oct. 2007).

⁸ Amended SBP, 16 C.F.R. 15444, 15520 (March 30, 2007).

⁹ 16 C.F.R. §436.8. Of note, the Amended Rule does not apply to business opportunities. The offer and sale of business opportunities are governed by 16 C.F.R. §437 and fall outside the scope of this paper. As briefly addressed in Section III.B below, some states also have adopted a state-level business

The Amended Rule defines the sale of a franchise to include any arrangement in which an investor obtains a franchise from a seller for value. Specifically excluded from the Amended Rule's definition of a sale is the extension or renewal of an existing franchise agreement, if the extension or renewal agreement does not contain materially different terms and if there is no interruption in the franchisee's operation of the business. Also excluded from the definition of a sale is the transfer of a franchise agreement by an existing franchisee in which the franchisor has no significant involvement.¹⁰

The Amended Rule governs the offer and sale of franchises throughout the United States. Included in the scope of the Amended Rule are all U.S. territories, specifically, Puerto Rico, Guam, Northern Mariana Islands, the U.S. Virgin Islands, and American Samoa.¹¹

3. Disclosure Obligations

As discussed above, the Amended Rule seeks to ensure that prospective franchisees receive adequate disclosure regarding the material aspects of the franchise relationship before entering into a franchise agreement. To that end, the Amended Rule prescribes not only the information that must be disclosed, but also the format and order in which the required disclosures must appear. The form of disclosure prescribed by the Amended Rule is referred to as a "Franchise Disclosure Document" ("FDD"). It consists of 23 "Items" covering a variety of subjects. In addition to the 23 Items of disclosure, each FDD must contain copies of all material contracts that franchisees must sign as a condition of doing business, the franchisor's financial statements, and other key information related to the franchise relationship (e.g., lists of current and former franchisees – including their contact information).¹² Franchisors are solely responsible for ensuring the adequacy and accuracy of the disclosures made.¹³

Preparing and maintaining an FDD is often a time-consuming and costly endeavor. However, most franchisors will agree that providing prospective franchisees with accurate and complete disclosure on the key aspects of the franchise relationship is beneficial to the franchisor and prospective franchisee. Educated prospective franchisees are able to make sound business decisions. Providing disclosure ensures that franchisees enter into the business relationship with "eyes wide open," thereby increasing the likelihood that they achieve success.

opportunity law. Franchisors subject to the Amended Rule are required, in some states, to file paperwork confirming the franchisor is exempt from the state's business opportunity law. Counsel is wise to review these laws and be prepared to guide clients through the exemption process related to business opportunities.

¹⁰ 16 C.F.R. §436.2(t).

¹¹ 16 C.F.R. §436.2.

¹² 16 C.F.R. §436.3.

¹³ 16 C.F.R. §436.6(a).

a. Timing for Disclosure and Delivery of the Franchise Agreement

Except as modified by a handful of states (as described in Section I.B below), the Amended Rule requires that franchisors provide each prospective franchisee with an FDD at least 14 calendar days before the prospect signs any binding contract with, or remits any consideration to, the franchisor or its affiliates.¹⁴ In calculating the 14-calendar day waiting period, the franchisor cannot count the day that it delivers the FDD to the prospect or the 14th day after receipt of the FDD.¹⁵ Effectively, this means that a total of 16 calendar days must pass between FDD delivery and the prospect signing or paying any money to the franchisor or its affiliates.

Prospective franchisees may request a copy of the FDD earlier in the franchise qualification process, and the Amended Rule requires a franchisor to comply with that request so long as it is “reasonable.”¹⁶ Determining what constitutes a “reasonable” request is left to the circumstances of each request, but generally includes the prospective franchisee’s completion of a franchise application and the commencement of the franchise sales process. Practically speaking, most franchisors provide the prospect with a copy of the FDD far earlier than 14-calendar days before the prospect is obligated to sign a binding contract with, or pay money to, the franchisor or its affiliates. In fact, a best practice is to provide disclosure as early in the process as possible to ensure that both parties have adequate time to engage with each other on the nuances of the business relationship and corresponding expectations.

If a franchisor unilaterally changes the terms of the form franchise agreement with which the franchisee was disclosed, or makes unilateral decisions regarding material terms of the franchise agreement such as the scope of the territory granted to the franchisee, the franchisor must provide a copy of the franchise agreement reflecting the changes or decisions at least seven calendar days before the franchisee signs an agreement with, or remits any consideration to, the franchisor.¹⁷ This mandatory seven calendar day waiting period does not apply if: (1) the only differences between the form agreement and the ready-for-execution version are non-substantive “fill-in-the-blank” provisions,¹⁸ or (2) the modifications to the agreement reflect changes initiated at the prospective franchisee’s request.¹⁹

¹⁴ 16 C.F.R. §436.2(a).

¹⁵ FTC, *Franchise Rule Compliance Guide* at p. 20 (May 2008), <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf> (hereafter, the “Compliance Guide”).

¹⁶ 16 C.F.R. §436.9(e).

¹⁷ Compliance Guide, *supra* note 15 at 22.

¹⁸ *Id.* According to the Compliance Guide, “fill-in-the-blank” provisions include items such as date, name and address of the franchisee. The addition of substantive terms such as a protected territory, interest rate, number of stores to be opened, or other contractual terms that were not previously disclosed in the FDD or its attachments will trigger the seven calendar day waiting period.

¹⁹ *Id.* at 23.

b. Electronic Disclosure

The Amended Rule explicitly addressed electronic disclosure. Under the Amended Rule, electronic disclosure may be made via email, CD-ROM, via a secure portal (where a prospect can access the password-protected document), or through any number of third-party electronic document delivery systems such as DocuSign and FDD Plus that specialize in helping franchisors comply with the technical aspects of tracking FDD delivery and signing dates.²⁰ Despite the Amended Rule's express acknowledgment of the electronic age in which we are living, it prohibits franchisor use of pop-ups, audio, video and links to external documents as such items could be distracting to the prospective franchisee and minimize the thrust of the content of the required disclosures.²¹ However, the Amended Rule permits franchisors to implement tools in electronic documents aimed at helping prospective franchisees to review an FDD more efficiently.²² These tools include scroll bars, search features, and internal links between disclosure items and other parts of the FDD.

Nearly every franchisor now utilizes electronic disclosure. Accordingly, the Amended Rule's additional requirement that the franchisor provide advance disclosure to prospects related to the form in which the FDD is available is part of most franchisors' standard operating procedures.²³ This "pre-disclosure disclosure" for electronic transmittal of an FDD often is made on the franchisor's website, franchise application, or cover letter that first engages the prospective franchisee in a dialogue about the opportunity.²⁴

A final issue that arises in connection with electronic disclosure of the FDD is the requirement that a franchisor furnish the FDD in a format that enables the prospective franchisee to keep the FDD for future reference.²⁵ Accordingly, if a franchisor elects to furnish the FDD as an email attachment or through a secure portal, the FDD must be in a format that the prospective franchisee can download to a computer or CD-ROM.²⁶ The FDD also must be printable as a single document, and may not be provided in multiple, discrete parts.²⁷ For example, a franchisor that provides the FDD as an email attachment may not also attach a separate copy of the Receipt pages for signing convenience. The purpose of the Receipt pages is to serve as confirmation that the prospective franchisee received the FDD – that purpose is lost if the Receipt pages are included as a separate attachment.

²⁰ 16 C.F.R. §436.2(c).

²¹ 16 C.F.R. §436.6(d).

²² Compliance Guide, *supra* note 15 at 122.

²³ See, 16 C.F.R. §436.6(g).

²⁴ Sample language for this type of disclosure may include the following sentence: "The Franchise Disclosure Document is available to you in one of three formats: Electronic PDF, paper hard copy, or via CD-ROM. To access PDF, you will need the most current version of Adobe Acrobat Reader installed on your PC."

²⁵ Compliance Guide, *supra* note 15 at 121.

²⁶ *Id.*

²⁷ *Id.*

B. State Regulation

In addition to the disclosure obligations prescribed by the Amended Rule, 15 states impose state-specific disclosure obligations on franchisors that supersede the requirements of the Amended Rule.²⁸ Generally speaking, these states have adopted the same disclosure obligations as codified in the Amended Rule with certain limited exceptions. A few of these states require a franchisor to provide the FDD to a prospective franchisee earlier in the sales process. These additional, state-specific disclosure obligations are detailed further in Sections II.C. below.

Of the 15 states that have enacted franchise disclosure laws, 14 of those states impose registration requirements in their respective jurisdictions.²⁹ These states specifically prohibit a franchisor from engaging in the offer and sale of franchises absent first securing an effective franchise registration with the applicable state agency. As discussed further in Section III below, the state registration process varies from state to state.

Registration and disclosure requirements aside, state franchise laws may also: (a) require franchisors to consent to jurisdiction within their respective states; (b) empower state regulatory authorities to review franchise disclosure documents to ensure compliance with applicable disclosure requirements; and (c) provide a private right of action for franchisees harmed by a franchisor's noncompliance. In many instances, state regulators are empowered to deny registration if the regulator believes a franchisor is too thinly capitalized or, alternatively, to require the franchisor to provide additional financial assurances as a condition to registration. State regulators also typically have the power to conduct their own investigations and to impose civil and administrative fines for noncompliance.³⁰

²⁸ *California Franchise Investment Law*, California Corporations Code, Div. 5, Parts 1-6, Section 31000 *et seq.*; *Hawaii Franchise Investment Law*, Hawaii Rev. Stat., Title 26, Ch. 482E, Section 482-E1 *et seq.*; *Illinois Franchise Disclosure Act*, Illinois Compiled Statutes, Ch. 815, Section 705/1 *et seq.*; Indiana Code, Title 23, Article 2, Ch. 2.5, Section 1 *et seq.*; *Maryland Franchise Registration and Disclosure Law*, Ann. Code of Maryland, Business Regulation, Title 14, Section 14-201 *et seq.*; *Michigan Franchise Investment Law*, Michigan Compiled Laws, Ch. 445, Section 445.1501 *et seq.*; *Minnesota Statutes*, Ch. 80C, Section 80C.01 *et seq.*; *New York General Business Law*, Art. 33, Section 680 *et seq.*; *North Dakota Franchise Investment Law*, North Dakota Century Code Ann., Title 51, Ch. 51-19, Section 51-19-01 *et seq.*; *Oregon Franchise Transactions Law*, Oregon Revised Statutes, Title 50 Ch. 650, Section 650.005 *et seq.*; *Rhode Island Franchise and Distributorship Investment Regulations Act*, General Laws of Rhode Island, Title 19, Ch. 28.1, Section 19-28.1-1 *et seq.*; *South Dakota Franchises for Brand-Name Goods and Services Law*, South Dakota Codified Laws, Title 37, Ch. 37-5B, Section 37-5B-1 *et seq.*; Virginia Retail Franchising Act, Virginia Code, Title 13.1, Ch. 8, Section 13.1-557 *et seq.*; *Washington Franchise Protection Act*, Revised Code of Washington, Title 19, Ch. 19.100, Section 19,100.010 *et seq.*; and *Wisconsin Franchise Investment Law*, Wisconsin Stats., Ch. 553, Section 553.01 *et seq.*

²⁹ See Note 28, excluding the Oregon Franchise Transactions law.

³⁰ Although outside the scope of this paper, several states have enacted "franchise relationship" statutes, which govern the circumstances under which a franchise relationship may be cancelled, terminated, not renewed or otherwise materially changed. See, Christine E. Connelly, Aron Friedman and Mark Inzetta, *Franchise Default and Termination – Best Practices to Enforce the Contract and Protect the System*, 49th Annual Legal Symposium (2016), for a primer on these laws.

Though each state is sovereign with respect to the enactment and enforcement of its own franchise sales law, the North American Securities Administrators Association (“NASAA”) – an international investor protection organization comprised of securities regulators – works to coordinate federal and state laws by proposing to the states for adoption uniform guidelines, laws, and model rules. Franchise regulators in California, Hawaii, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin are members of NASAA through their affiliation with their state’s securities agency, which regulates franchising in the state. Franchise regulators in Illinois and Michigan are not NASAA members because, there, franchising is regulated by the state attorneys’ general offices. But NASAA works closely with the attorneys general offices in these states on franchise-related issues. While NASAA has no *direct* authority over franchising, NASAA’s Franchise and Business Opportunity Project Group (a standing committee formed in the 1980s) substantially contributed to the franchise laws and registration procedures that exist today.

NASAA’s recommendations and policy initiatives traditionally have been given great weight by the states that regulate franchises and are sometimes incorporated by reference into state law. On April 27, 2009, in response to the enactment of the Amended Rule, NASAA adopted the 2008 Franchise Registration and Disclosure Guidelines (the “NASAA Guidelines”) as a model for states with franchise registration and disclosure laws.³¹ On May 8, 2017, NASAA adopted the NASAA Commentary on Financial Performance Representations (the “FPR Commentary”).³²

Practitioners tasked with managing the franchise disclosure and registration process are advised to review the various state franchise registration and disclosure laws, the NASAA Franchise Registration and Disclosure Guidelines, and the FPR Commentary prior to submitting a franchise registration application to a particular state.

II. Franchise Disclosure Document

As noted above, the Amended Rule requires a franchisor to provide a prospective franchisee with an FDD that contains 23 Items of disclosure that correspond with the requirements of the Amended Rule. This Section II provides a brief summary of the key disclosures required in each of the 23 Items. This Section II does not, however, address and identify every disclosure required by the Amended Rule.

A. Drafting Tips and Tools

The Amended Rule requires franchisors to disclose all information clearly, legibly, and in plain English.³³ The Amended Rule considers “plain English” to include words and phrases understandable by a person unfamiliar with the franchised

³¹ Commentary on 2008 Franchise Registration and Disclosure Guidelines, www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf

³² NASAA Franchise Commentary Financial Performance Representations, <http://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf>

³³ 16 C.F.R. §436.6(b).

business.³⁴ Drafters of FDDs should use short sentences, everyday language, active voice and avoid legal jargon and highly technical business terms.

The content of the FDD must be limited to (i) the specific requirements imposed by the Amended Rule or state law and (ii) any specific disclosures required by a state regulator. Extraneous information that is not responsive to these specific requirements or disclosures must be omitted.³⁵ When preparing an FDD, a franchisor must address every disclosure requirement outlined in the Amended Rule.³⁶ If any required disclosure is not applicable to the franchise system, then the FDD must include a negative response to the required disclosure. Similarly, if a statement is prescribed or required by the Amended Rule, the content of such statement cannot be modified and must be presented verbatim as specified in the Amended Rule.³⁷

When making disclosures in one Item of an FDD, cross-references to other Items of the FDD can be helpful to provide readers with additional information. However, some state regulators prefer that these cross-references be omitted to the extent those references cause confusion for readers of the FDD who may not be familiar with the layout and function of the FDD.

The following tools and materials are helpful guidance in drafting or updating an FDD.

- Amended Rule³⁸
- Amended SBP³⁹
- Compliance Guide⁴⁰
- FTC Amended Rule FAQs⁴¹
- NASAA Guidelines⁴²
- NASAA Commentary on 2008 Guidelines⁴³
- NASAA Multi-Unit Commentary⁴⁴
- The FPR Commentary⁴⁵
- FTC Informal Advisory Opinions⁴⁶

³⁴ 16 C.F.R. §436.1(o).

³⁵ 16 C.F.R. §436.6(d).

³⁶ 16 C.F.R. §436.6(c).

³⁷ Compliance Guide, *supra note 15* at 122.

³⁸ 16 C.F.R. §436

³⁹ Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15,444 (March 30, 2007) or <https://www.ftc.gov/sites/default/files/070330franchiserulefrnotice.pdf>

⁴⁰ <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf>

⁴¹ FTC Rule FAQs, <https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs>

⁴² <http://www.nasaa.org/wp-content/uploads/2011/08/2008UFOC1.pdf>

⁴³ http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf

⁴⁴ <http://www.nasaa.org/wp-content/uploads/2011/08/Franchise-Multi-Unit-Commentary-effective-Adopted-Sept.-16-2014.pdf>

⁴⁵ NASAA Franchise Commentary Financial Performance Representations, <http://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf>

⁴⁶ <https://www.ftc.gov/policy/advisory-opinions>

B. Federal Disclosure Requirements

1. Federal Cover Page

The FDD begins with a federal cover page. The federal cover page explains to prospective franchisees the purpose of the FDD, basic information about the franchise system and certain protection mechanisms that have been put in place for franchisees.⁴⁷ On the federal cover page, the Amended Rule requires a franchisor to include certain scripted language and other information in a required order and form. Specifically, the Amended Rule requires the title of the FDD – “**FRANCHISE DISCLOSURE DOCUMENT**” – to appear in both capital letters and boldface type.⁴⁸ The title must be followed by basic information about the franchisor – i.e., name, type of business organization, principal business address, telephone number and the franchisor’s email address and web page – the primary business trademark for the franchise system, and a brief description of the franchised business.⁴⁹ The federal cover page must also include the following statements:

The total investment necessary to begin operation of a [franchise system name] franchise is [the total amount of Item 7]. This includes [the total amount in Item 5] that must be paid to the franchisor or affiliate.⁵⁰

This disclosure document summarizes certain provisions of your franchise agreement and other information in plain English. Read this disclosure document and all accompanying agreements carefully. You must receive this disclosure document at least 14 calendar-days before you sign a binding agreement with, or make any payment to, the franchisor or an affiliate in connection with the proposed franchise sale. **Note, however, that no governmental agency has verified the information contained in this document.**⁵¹

[OPTIONAL] You may wish to receive your disclosure document in another format that is more convenient to you. To discuss the availability of disclosures in different formats, contact [name or office] at [address] and [telephone number].⁵²

The terms of your contract will govern your franchise relationship. Don’t rely on the disclosure document alone to understand your contract. Read all of your contract carefully. Show your contract and this disclosure document to an advisor, like a lawyer or an accountant.⁵³

⁴⁷ 16 C.F.R. §436.3.

⁴⁸ *Id.*

⁴⁹ *Id.*

⁵⁰ 16 C.F.R. §436.3(e)(1).

⁵¹ 16 C.F.R. §436.3(e)(2).

⁵² 16 C.F.R. §436.3(f).

⁵³ 16 C.F.R. §436.3 (e)(3).

Buying a franchise is a complex investment. The information in this disclosure document can help you make up your mind. More information on franchising, such as “*A Consumer’s Guide to Buying a Franchise*,” which can help you understand how to use this disclosure document, is available from the Federal Trade Commission. You can contact the FTC at 1-877-FTC-HELP or by writing to the FTC at 600 Pennsylvania Avenue, NW, Washington, D.C. 20580. You can also visit the FTC’s home page at www.ftc.gov for additional information. Call your state agency or visit your public library for other sources of information on franchising.⁵⁴

There may also be laws on franchising in your state. Ask your state agencies about them.⁵⁵

Finally, the federal cover page must include the issuance date for the FDD, which is the date that the franchisor finalizes the FDD.⁵⁶

In addition to the federal cover page, the FDD must include a state cover page with certain risk factors⁵⁷ that are discussed in Section II.C.2 below.

2. Item 1: The Franchisor and Any Parents, Predecessors and Affiliates

Item 1 requires that the franchisor provide an overview of the franchise opportunity and explain the type of business the franchisee will operate. The franchisor must also disclose specific background information about the franchisor and any parent, affiliate, or predecessor and whether or not any of them operate the business being franchised or offer franchises for any other line of business.⁵⁸ Franchisors also must disclose any other business activities in which they engage.⁵⁹ Item 1 also requires a brief explanation of the types of laws and regulations applicable to the franchised business, as well as general information about the market for the franchise business and the types of businesses that compete with the franchised business.⁶⁰

3. Item 2: Business Experience

Item 2 requires that the franchisor disclose the business experience for the past five years of its directors, principal officers, trustees, general partners and all other individuals who will have “management responsibility” related to the sale or operation of franchises.⁶¹ Franchisors must make the disclosures in Item 3 and Item 4 for each individual listed in Item 2.

⁵⁴ 16 C.F.R. §436.3 (e)(4).

⁵⁵ 16 C.F.R. §436.3 (e)(5).

⁵⁶ Compliance Guide, *supra* note 15 at 26.

⁵⁷ 16 C.F.R. §436.3(g).

⁵⁸ 16 C.F.R. §436.5(a).

⁵⁹ 16 C.F.R. §436.5(a).

⁶⁰ *Id.*

⁶¹ Compliance Guide, *supra* note 15 at 33.

4. Item 3: Litigation

Item 3 requires franchisors to disclose certain types of litigation. The first litigation category required to be disclosed are certain actions against the franchisor or any of its predecessors, parents and affiliates that have occurred during the 10-year period preceding the date of the FDD. The types of litigation included in this category are currently pending and prior litigation and currently effective government orders which involve allegations of a violation of franchise, antitrust, or securities laws or fraud, unfair or deceptive practices or comparable allegations. For each of these actions, the franchisor must describe specific information about the particular action and provide a summary of the relief sought or obtained and any conclusions of law or fact.⁶²

The second litigation category that must also be disclosed in Item 3 are franchisor-initiated actions during the franchisor's preceding fiscal year that involve the franchise relationship. For these litigation disclosures, multiple actions of the same type may be listed under common headings.⁶³ This type of litigation generally consists of collection actions against current and former franchisees and actions to enforce noncompete covenants and system standards.

As described above, litigation involving persons disclosed in Item 2 also may be required to be disclosed in Item 3 if the nature of the litigation could influence a prospective franchisee's investment decision.⁶⁴

5. Item 4: Bankruptcy

Item 4 requires disclosure of all bankruptcies that have occurred during the 10-year period preceding the date of the FDD which involve the franchisor or any of its predecessors, parents, affiliates or any of the persons disclosed in Item 2.⁶⁵

6. Item 5: Initial Fees

Item 5 requires disclosure of the amount and types of fees collected by the franchisor or its affiliates from the franchisee prior to the opening of the franchised business including the initial franchise fee.⁶⁶ Most franchisors disclose these fees in the chronological order that the franchisee will pay the fees. The Amended Rule also requires the franchisor to disclose whether the fees are uniformly imposed and whether any of the required fees are refundable. Where any of the fees are not uniformly imposed, the franchisor must provide the range of fees collected during its prior fiscal year or the formula used to determine the amount of the fee paid by each franchisee.⁶⁷

⁶² 16 C.F.R. §436.5(c).

⁶³ 16 C.F.R. §436.5(c).

⁶⁴ While lawsuits against Item 2 individuals related to "routine business matters" need not be disclosed in Item 3, counsel for franchisors must critically assess the inclusion of such lawsuits under the materiality standard based on all facts and circumstances.

⁶⁵ 16 C.F.R. §436.5(d).

⁶⁶ 16 C.F.R. §436.5(e).

⁶⁷ *Id.*

7. Item 6: Other Fees

Item 6 requires disclosure, in a four column table, of all fees associated with operating a franchised outlet that the franchisee will or may pay to the franchisor and its affiliates, other than the initial fees already disclosed under Item 5.⁶⁸ This includes both recurring fees such as royalties and advertising fund contributions and occasional fees such as transfer or renewal fees. In addition to royalties and advertising contributions, most franchisors also charge, or reserve the right to charge, other fees in certain circumstances. Also, many franchisors reserve the right to be reimbursed for certain costs they incur on behalf of franchisees. Payments made to, or collected by, the franchisor (or one of its affiliates) as a pass-through of fees imposed by third parties (such as a lease deposit for a sublease or licensing fees for 3rd party software) must also be disclosed.⁶⁹ Franchisors must conduct a thorough review of their franchise system to ensure all of the fees, payments and reimbursements are properly reflected in Item 6.

In addition to identifying all of the types of fees that need to be included in Item 6, the disclosure must include a description of the nature and frequency of each fee, including whether or not such fee is subject to adjustment, and if so, on what basis the fee may increase. As with the disclosure in Item 5, franchisors must also disclose whether the fees in Item 6 are uniformly imposed among all franchisees and outlets, and whether (and under what circumstances, if any) the fees are refundable.⁷⁰

8. Item 7: Estimated Initial Investment

Item 7 requires the disclosure, in a prescribed five-column table, of the estimated initial investment costs a franchisee can expect to incur to construct and open its franchised business and the additional funds necessary to operate the franchised business during the “initial phase” of operations.⁷¹ The table must clearly identify the type of expenditure, amount due or payable, method of payment, when the payment is due, and to whom the payment must be made.⁷² Many of these expenses are often paid to third parties and are not previously disclosed in Items 5 or 6. The list of expenditures in Item 7 is not meant to be exhaustive because each franchisee’s experience is unique and may vary from other outlets from which the cost estimates were compiled. Despite this, certain categories of costs are fairly standard throughout most franchise systems including (1) initial franchise fee, (2) training expenses, (3) real property (purchased or leased), (4) equipment, (5) beginning inventory, (6) business licenses and fees, and (7) a category for “additional funds” which are additional monies a franchisee likely needs during the “initial phase” of operations, typically three months after opening.⁷³

⁶⁸ 16 C.F.R. §436.5(f).

⁶⁹ Compliance Guide, *supra note 15* at 45.

⁷⁰ 16 C.F.R. §436.5(f)(4).

⁷¹ 16 C.F.R. §436.5(g).

⁷² *Id.*

⁷³ 16 C.F.R. §436.5(g)(1)(i)-(iii).

Each franchisor must carefully consider the types of costs that its franchisees will likely incur. Even franchise systems that operate in a similar manner or industry often have significant differences in their Item 7 estimates due to the nuances of their operations. For instance, some franchisees incur costs for deposits, site selection fees, real estate brokerage fees, insurance, and professional fees, and these types of costs should not be overlooked.

The second column of the Item 7 table requires the franchisor to provide a dollar amount for each type of cost. Most franchisors provide a low-high range based on the experience of the franchisor and its market research. Footnotes should be used to explain any assumptions made by the franchisor, the variability of the costs disclosed, the methodology used to make any calculations and any differences that may impact individual franchisees. The total investment at the bottom of Item 7 should equal the sum of the individual cost items included in the table, and the amounts listed as being paid to the franchisor should also match the disclosures in Items 5 and 6.

Some franchisors include a provision in their Franchise Agreement that requires franchisees to provide a breakdown to the franchisor of the costs the franchisee incurred as part of its initial investment in order to assist the franchisor in providing accurate information in its Item 7 table.

9. Item 8: Restrictions on Sources of Products and Services

Item 8 requires disclosure of any restriction that the franchisor imposes on the source of products and services purchased by its franchisees. Many franchisors restrict the source from which a franchisee can obtain certain products and services to better control the uniformity of the brand across all of the outlets in the franchise system. For each restriction, the franchisor must explain: (a) the item that the franchisee is required to purchase or lease; (b) the designated or approved supplier(s) for that item (including whether the franchisor or its affiliates are the only supplier one of the approved suppliers); (c) whether the franchisor or any of its affiliates or management team owns an interest in any designated or approved supplier; (d) whether the franchisor issues specifications and standards for the item and how those specifications are modified; and (e) the process the franchisor uses to grant and revoke approval of a particular supplier.⁷⁴

Some franchisors receive rebate payments and other types of consideration and benefits from suppliers based on the volume of purchases by the franchise system, and when they do, the franchisor must disclose the precise basis for these types of payments and benefits and the amount of revenue that the franchisor receives from suppliers.⁷⁵ When the franchisor derives revenue based on purchases by franchisees, Item 8 also requires that the franchisor disclose: (1) the franchisor's total revenue, (2) the franchisor's revenues from all required purchases and leases of products and services by franchisees, (3) the percentage of the franchisor's total revenues that come from purchases or leases by franchisees that are required by the franchisor, and (4) the

⁷⁴ 16 C.F.R. §436.5(h).

⁷⁵ 16 C.F.R. §436.5(h)(8).

revenues received by affiliates of the franchisor from purchases or leases by franchisees that are required by the franchisor.⁷⁶

Finally, Item 8 requires franchisors to address several other areas that relate to purchases made by franchisees including the following: (a) the estimated percentages of a franchisee's required purchases and leases in proportion to all purchases and leases by a franchisee in both establishing and operating the franchised business; (b) whether or not there are purchasing cooperatives in the franchise system; (c) whether or not the franchisor negotiates purchasing terms with suppliers; and (d) whether or not the franchisor provides any material benefit to franchisees that purchase product from a designated or approved supplier.⁷⁷

10. Item 9: Franchisee's Obligations

Item 9 requires that the franchisor prepare a three-column table that clearly shows certain information in the following three columns: (1) a list of the franchisee's obligations under the franchise agreement (or any other relevant agreement between franchisor and franchisee), (2) the section in that agreement that contains the franchisee's obligation, and (3) the corresponding "Item" in the FDD that discusses the obligation.⁷⁸ There is a prescribed list of franchisee obligations that must be addressed in the Item 9 table even if the franchisor merely states "Not Applicable" next to certain of those obligations. Franchisors can also add additional obligations that are applicable to their franchise system by adding those obligations at the end of the table. Item 9 must also contain a mandatory statement. A sample Item 9 chart is attached as Exhibit A.

11. Item 10: Financing

Item 10 requires the franchisor to disclose whether or not the franchisor (or any of its affiliates or agents) provides any financing (directly or indirectly) to franchisees. The term financing is interpreted broadly to include guaranties of franchisee loan and lease obligations.⁷⁹ If the franchisor provides one of these types of financing, Item 10 must explain the financing arrangement, the lender and the relationship between the lenders and the franchisor as well as the key terms of the financing arrangement. Franchisors are permitted to disclose this information in a table and an example of an Item 10 table is attached as Exhibit B.⁸⁰ However, franchisors are permitted to disclose the information in another format, and if a table is used, most franchisors supplement the information in the table with explanatory notes.

12. Item 11: Franchisor's Assistance, Advertising, Computer Systems and Training

Item 11 covers the various forms of assistance that the franchisor provides to its franchisees. Due to the significant amount of information on a variety of topics that are

⁷⁶ 16 C.F.R. §436.5(h)(6).

⁷⁷ 16 C.F.R. §436.5(h)(7),(9)-(11).

⁷⁸ 16 C.F.R. §436.5(i).

⁷⁹ 16 C.F.R. §436.5(j).

⁸⁰ 16 C.F.R. §436.5(j).

required to be disclosed in Item 11, most franchisors attempt to provide this information in a clear and concise manner that is easy for prospects to understand by using subheadings for each category of disclosure and charts or lists whenever possible.

The first disclosure in Item 11 requires that the franchisor disclose its pre-opening and ongoing obligations to its franchisees and provide references to the section in the agreement that establishes each obligation.⁸¹ Prior to the disclosure of the specific types of assistance that the franchisor will provide, Item 11 requires that the following language be included **“except as listed below, [the franchisor] is not obligated to provide you with any assistance.”**⁸² Following this introduction, most franchisors list the specific types of assistance in separate paragraphs identifying the specific pre-opening assistance provided to franchisees (such as site location assistance and site approval requirements) and the specific continuing assistance provided after the franchised business begins operations (such as call center support and customer leads).⁸³ All of the franchisor’s obligations to provide assistance must be disclosed. The Amended Rule provides a list of possible obligations that the franchisor may undertake, but the franchisor is only required to disclose those obligations that apply to its franchise system.⁸⁴ Some franchisors often make disclosures in Item 11 about assistance that may or may not be provided at the option of the franchisor or make disclosures about rights that are reserved. In some instances, state examiners will require disclosures about these types of “optional” assistance be removed from the FDD.

After the disclosure of the franchisor’s pre-opening and ongoing obligations, Item 11 requires several specific disclosures with respect to certain types of assistance provided by the franchisor. First, the franchisor must describe its advertising programs including: (a) whether the franchisee must conduct local advertising; (b) the types of media used for advertising (e.g., print, radio, television, internet); (c) the source of the advertising; (d) the geographical scope of advertising (e.g., local, regional or national); (e) whether franchisees must contribute to an advertising fund or spend any specific amounts toward advertising in their local markets; and (f) the role of advertising councils or cooperative associations (and a description of how they operate).⁸⁵ With respect to advertising funds, franchisors must disclose the amount of the franchisee’s required contribution to the fund and the uses of the monies held in the fund during the preceding year.⁸⁶

Item 11 also requires that franchisors provide a general description in non-technical language of the computer systems (including POS systems and electronic cash register systems) that franchisees must purchase or lease and the costs associated with those systems. Franchisors must also identify: (a) whether the franchisor, an affiliate or another third party will provide ongoing maintenance, repairs, upgrades or updates; (b) whether the franchisee has any obligation to upgrade or

⁸¹ 16 C.F.R. §436.5(k)

⁸² 16 C.F.R. §436.5(k).

⁸³ 16 C.F.R. §436.5(k)(1) and (3).

⁸⁴ *Id.*

⁸⁵ 16 C.F.R. §436.5(k)(4).

⁸⁶ 16 C.F.R. §436.5(k)(4)(v).

update the systems; (c) whether there is any contractual limitation on the frequency and cost of such upgrades or updates; and (d) whether the franchisor has access to the data that is captured on those systems.⁸⁷ In addition, for some start-up franchisors, the computer system requirements may not have been finalized. The Compliance Guide specifically provides that a franchisor may indicate that the computer requirements are yet to be determine or otherwise state its policy concerning computer usage.⁸⁸

Item 11 must also describe the training program in a specific table that explains the requirements for both “on-the-job” training and classroom training. The subject matter and number of hours for each aspect of training must be included in a table following a specific format. Franchisors must identify: (a) the individuals within the franchisee’s organization who must attend training; (b) whether all or some of franchisee’s attendees must successfully complete training; and (c) the costs to attend training such as tuition and travel costs. The franchisor also must identify the individuals within the franchisor’s organization who will conduct and administer the training and the length of experience each trainer has been in the field and with the franchisor. The location of the training and the timing of the training classes must also be addressed in Item 11.⁸⁹

Most franchisors disclose the table of contents of their operations manual to meet the applicable Item 11 disclosure requirements regarding operations manuals.⁹⁰ However, as an alternative, a franchisor may provide a copy of the entire manual to prospective franchisees prior to consummating a franchise sale. If the franchisor chooses this alternative, the franchisor will likely want each prospect to sign a confidentiality agreement. If the franchisor requires franchisees to sign a confidentiality agreement for this purpose, it must also disclose that requirement and include the form of confidentiality agreement as an exhibit to the FDD.

13. Item 12: Territory

Item 12 informs prospects about the location of the franchised business and the territorial protection associated with the franchised business. Franchisors must disclose whether franchises are sold for specific locations or are sold based upon a defined territory or some combination of location and territory. If the franchisor grants franchisees a specific territory, the disclosure must explain: (a) the methodology the franchisor uses to determine each territory; (b) any conditions that the franchisee must meet to obtain and/or maintain territorial protection; and (c) the restrictions placed on both the franchisor and the franchisee within that territory.⁹¹ The franchisor also must specify whether or not, and to what extent, a franchisee may solicit sales outside of its territory.⁹²

⁸⁷ 16 C.F.R. §436.5(k)(5).

⁸⁸ FTC *Franchise Rule Compliance Guide*, p. 67.

⁸⁹ 16 C.F.R. §436.5(k)(7).

⁹⁰ 16 C.F.R. §436.5(k)(6).

⁹¹ 16 C.F.R. §436.5(l).

⁹² 16 C.F.R. §436.5(l)(6)(ii).

Many franchisors reserve certain rights within a franchisee's territory such as the right to distribute products and services through non-traditional venues. When the franchisor reserves these types of rights within the franchisee's territory, the FTC takes the position that the franchisor does not grant an exclusive territory to the franchisee,⁹³ and the Amended Rule requires that Item 12 include the following statement:

You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control.⁹⁴

Many franchisors also reserve the right to distribute products and services within a franchisee's territory through alternative channels of distribution such as internet sales, telemarketing sales or other types of direct marketing. The reservation of these rights must be disclosed in Item 12 with respect to products and services offered in the franchised business and with respect to any other products and services that franchisor has reserved the right to sell through alternative channels.⁹⁵

Item 12 also requires that the franchisor state the conditions upon which the franchisor will allow the franchisee to relocate the location of the franchised business or establish new outlets or obtain options, rights of first refusal or other rights to acquire additional franchise units.⁹⁶ Finally, any franchisor that offers area development agreements that grant a franchisee (or developer) the right to open multiple locations within a geographic area must disclose the key territorial provisions of the area development agreement in Item 12.⁹⁷

14. Item 13: Trademarks

As a principal element of any franchise relationship is a trademark license, prospective franchisees must receive certain disclosures related to the primary marks associated with the franchised business they intend to operate, including the registration status of each mark, any limitations on the franchisee's use of the mark (through settlement agreement or otherwise), and whether the marks have been contested via court actions or administrative proceedings.⁹⁸ Each disclosure is intended to assist the franchisee in determining the strength of the mark and the validity of the trademark license granted to the franchisee. Further, as to any primary mark that does not have an effective registration (including marks that are pending registration) with the United States Patent and Trademark Office, the Amended Rule requires the franchisor to include the following language in Item 13:

We do not have a federal registration for our principal trademark. Therefore, our trademark does not have as many legal benefits and rights

⁹³ FTC FAQ #37.

⁹⁴ 16 C.F.R. §436.5(l)(5)(i).

⁹⁵ 16 C.F.R. §436.5(l)(6)(i).

⁹⁶ 16 C.F.R. §436.5(l)(3)-(4).

⁹⁷ 16 C.F.R. §436.5(l)(2).

⁹⁸ 16 C.F.R. §436.5(m).

as a federally registered trademark. If our right to use the trademark is challenged, you may have to change to an alternative trademark, which may increase your expenses.⁹⁹

15. Item 14: Patents, Copyrights and Proprietary Information

Item 14 seeks to provide information to prospective franchisees related to other intellectual property of the franchisor that is used in the operation of the franchise system and franchised businesses.¹⁰⁰ Nearly all franchisors seek to highlight the confidential nature of their operating manuals by specifically listing the operating manuals in Item 14 and noting that all information contained therein is not only proprietary and confidential to the franchisor, but subject to common law copyright protection. Some franchise systems rely on certain technologies or protected processes in connection with the products and services provided by franchised outlets, and for these franchise systems, disclosures related to these protected technologies or processes must be referenced in Item 14. The disclosures are similar to the Item 13 disclosures, in that the franchisor must generally identify the protected technology or process and provide statements as to any limitations on the franchisee's use of such items (through settlement agreements or otherwise), and whether the protected items have been contested via court actions or administrative proceedings.¹⁰¹ Recognizing that litigation is common with respect to trade secrets, patents and proprietary information, franchisors may include an attorney's opinion as to the merits of any court action or administrative proceeding provided that the attorney consents to inclusion of its opinion in the FDD.¹⁰²

16. Item 15: Obligation to Participate in the Actual Operation of the Franchised Business

Item 15 notifies the prospective franchisee about the franchisor's requirements and expectations related to franchisee involvement in the business.¹⁰³ Some franchise systems allow franchisees to retain third-party managers to manage the day-to-day operations of the franchised business, while other franchisors require that a franchisee be intimately involved in the day-to-day business operations. Franchisors must describe these requirements in Item 15, including the minimum experience and equity requirements for a third-party manager and any confidentiality or other covenants required of a third-party manager.¹⁰⁴ As a best practice, most franchisors also disclose in Item 15 whether a franchisor will require a guaranty from the franchisee's principals if the franchisee is a corporation, partnership, or other legal entity.

⁹⁹ 16 C.F.R. §436.5(m)(4).

¹⁰⁰ 16 C.F.R. §436.5(n).

¹⁰¹ *Id.*

¹⁰² 16 C.F.R. §436.5(n)(3).

¹⁰³ 16 C.F.R. §436.5(o).

¹⁰⁴ 16 C.F.R. §436.5(o)(2).

17. Item 16: Restrictions on What the Franchisee May Sell

As noted earlier, uniformity of products and services is a hallmark of franchise systems. As such, it comes as no surprise that the FDD must describe limitations on a franchisee's ability to sell products and services. Item 16 specifically requires the franchisor to describe whether the franchisee may sell only items approved by the franchisor and whether the franchisee must sell all goods and services authorized by the franchisor. Importantly, franchisors must disclose whether they have the right to change the types of goods and services franchisees must sell, and whether there are any limitations on the franchisor's right to prescribe such changes.¹⁰⁵

18. Item 17: Renewal, Termination, Transfer and Dispute Resolution

Item 17 contains a chart with detailed disclosures about the material contractual terms of the franchise relationship, including a description of the term of the franchise agreement and any other agreement material to the franchise relationship, as well as renewal rights, a description of the circumstances under which the franchisor and franchisee may terminate the relationship, restrictions on either party's right to transfer, a description of the franchisee's in-term and post-term non-compete covenants, the law governing the agreements material to the relationship, and the dispute resolution procedures set forth in the agreements material to the relationship. These disclosures must (1) be presented in a chart format, (2) identify each obligation, and (3) provide a reference to the section in the franchise or other agreement setting forth the obligation, and (4) provide a summary description of the obligation.¹⁰⁶ An example of an Item 17 chart is attached hereto as Exhibit C.

19. Item 18: Public Figures

Some franchise systems use an affiliation with a publicly recognizable figure (e.g. an athlete, actor, musician or other celebrity) to help them attract prospective franchisees and, ultimately, sell franchises.¹⁰⁷ In Item 18 of the FDD, franchisors must disclose the nature of the affiliation, including whether the public figure is involved in the ownership or management of the franchise system, or whether the public figure is a paid spokesperson.¹⁰⁸ As to the latter point, if the public figure is a paid spokesperson, compensation details must be disclosed.¹⁰⁹ Franchisors need not make Item 18 disclosures for public figures that help attract customers to the products and services associated with the franchised system and brand, so long as the public figure is not used in the offer and sale of franchises.¹¹⁰

¹⁰⁵ 16 C.F.R. §436.5(p).

¹⁰⁶ 16 C.F.R. §436.5(q).

¹⁰⁷ For example, Papa John's International, Inc. disclosed in its 2013 FDD that Peyton Manning was a public figure for the Papa John's franchise system.

¹⁰⁸ 16 C.F.R. §436.5(r).

¹⁰⁹ 16 C.F.R. §436.5(4)(1).

¹¹⁰ Compliance Guide, *supra note 15* at 84.

20. Item 19: Financial Performance Representations

Given that the principal aim of the franchise regulatory framework is to prevent fraud and misrepresentation in connection with the offer and sale of franchises, it is no surprise that the Amended Rule, state laws, and the FPR Commentary strictly regulate the form and substance of financial performance representations. Long known as “earning claims,” the Amended Rule adopted the term “financial performance representation” (or “FPR”), recognizing that certain types of franchise systems use unique metrics beyond “earnings” to assess financial health of the business (for example, hotel franchisors use room occupancy rates).

In fact, Section 436.1(e) of the Amended Rule defines a “financial performance representation” broadly, as follows:

Financial performance representation means 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. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.¹¹¹

Essentially, an FPR is any statement to a prospective franchisee regarding the return on investment they may achieve or that others have achieved. Regardless of whether a franchisor decides to make an FPR in Item 19, the Amended Rule requires the franchisor to begin its Item 19 disclosure with the following preamble:

The FTC’s Franchise Rule permits a franchisor to provide information about the actual or potential financial performance of its franchised and/or franchisor-owned outlets, if there is a reasonable basis for the information, and if the information is included in the disclosure document. Financial performance information that differs from that included in Item 19 may be given only if: (1) a franchisor provides the actual records of an existing outlet you are considering buying; or (2) a franchisor supplements the information provided in this Item 19, for example, by providing information about possible performance at a particular location or under particular circumstances.¹¹²

The decision to include an FPR in the FDD is personal to each franchisor. The Amended Rule made clear, however, that specific language must be included “word-for-word” in Item 19 if a franchisor declines to make a financial performance representation. That language is as follows:

We do not make any representations about a franchisee’s future financial performance or the past financial performance of company-owned or franchised outlets. We also do not authorize our employees or

¹¹¹ 16 C.F.R. §436.1(e).

¹¹² 16 C.F.R. §436.5(s)(1).

representatives to make any such representations either orally or in writing. If you are purchasing an existing outlet, however, we may provide you with the actual records of that outlet. If you receive any other financial performance information or projections of your future income, you should report it to the franchisor's management by contacting [name, address, and telephone number], the Federal Trade Commission, and the appropriate state regulatory authorities.¹¹³

If a franchisor seeks to make any financial performance representation, the FPR must be disclosed in Item 19 of the franchisor's FDD, unless the FPR involves the actual operating results of a specific outlet being sold, or unless the franchisor is making an FPR that supplements the disclosures provided in Item 19 of its FDD.¹¹⁴ The franchisor also must have a "reasonable basis" for the representation at the time the representation is made. The Compliance Guide has defined "reasonable basis" with reference to a number of factors, including, among others, that the FPR is grounded in written factual information that supports the representation at the time it was made and that the written information would be meaningful to a "prudent businessperson" as part of their decision-making process related to the particular franchise opportunity at hand.¹¹⁵ For example, in the FPR Commentary, NASAA determined that a franchisor's use of company-owned outlets alone is not "reasonable" when the franchisor has operational franchised outlets in the system.¹¹⁶

Financial performance representations can be based on historical information or projections of future performance, with the latter type of disclosure being subject to even greater scrutiny than already exists for FPRs generally.¹¹⁷ For efficiency and relevancy, the remainder of this section will focus on the requirements associated with an historical performance projection, as historical projections are the most commonly provided level of performance (and, arguably, the most relevant given that prospective franchisees can gauge the actual performance of franchised outlets).

One relatively common, albeit basic, type of historical financial performance representation includes a statement of "average gross sales," although as noted in the opening paragraph of this section, other metrics (such as occupancy rates, customer counts, "gross profit," and the like) may be more meaningful depending on the business model at hand. In any event, a franchisor making a financial performance representation must detail, in writing, the surrounding material context for the

¹¹³ 16 C.F.R. §436.5(s)(2).

¹¹⁴ 16 C.F.R. §436.9(c). Representations outside of the FDD are expressly prohibited unless they involve the actual historical operating results of a specific outlet that the prospective franchisee intends to purchase. See also, Compliance Guide, *supra* note 15 at 93.

¹¹⁵ Compliance Guide, *supra* note 15 at 135.

¹¹⁶ FPR Commentary at 19.8.

¹¹⁷ Franchisors must proceed cautiously with respect to including FPRs grounded in projections of future performance, as absent robust disclosure related to all elements of the projection (and why those elements support the franchisor's projection of future performance metrics to be attained by the prospective franchisee), a franchisor could find itself not only in violation of applicable federal and state disclosure requirements but perhaps also defending a variety of fraud and misrepresentation claims. See, Compliance Guide, *supra* note 15 at 135-136 for additional detail on making reasonable projections of future performance.

information provided. Using the example of an historical “average gross sales” FPR, the franchisor must ensure that its Item 19 statement details the following important information, such that a prospective franchisee views the Item 19 statement with the full context in which it is framed:¹¹⁸

- Clear identification of the “group measured” – In other words, is the franchisor’s FPR based on the performance of all outlets in the system, or only a subset of outlets? Remember that company-owned outlet performance alone is not an acceptable substitute for franchised outlet performance. Further, the recent NASAA commentary specifically prohibits a franchisor from measuring the performance of its best performing outlets without also disclosing the corresponding measurements for its lowest performing outlets.¹¹⁹ In short, franchisors must ensure that it clearly identifies the group measured and the basis for that measurement.
- Statement of the time period at play – Over what period of time did the measurement occur? Franchisors must ensure that the time period measured is relevant in light of facts and circumstances present at the time the FPR is made.
- Contrast between the number of outlets that were measured and the number of outlets that actually reported – In other words, franchisors should articulate the reasons why not all outlets eligible to be measured were included in the actual measurement. For example, is the sample to be measured limited to outlets that have been in operation for 12 months or longer? Is the sample tied to a specific type of operating style in a system with different service styles or formats? Franchisors must ensure that all relevant information is presented so that prospective franchisees understand the full scope (and limitations) of the FPR provided.
- The number and percentage of outlets that achieved the stated performance – This ensures that prospective franchisees easily can identify whether the stated performance level (average gross sales, for example) was achieved by a majority of the franchised outlets or whether one or two high volume locations skewed the average.
- Median/High-Low – The “median” as well as the “actual high” and “actual low” performance figures for outlets included in the sample.¹²⁰
- Other material information – This is the catch-all where franchisors must identify any other material information, which if known, would add or retract from the likelihood that a prospective franchisee might achieve similar performance to that stated in Item 19. For example, franchisors should ask themselves whether the stated performance level varies by geography,

¹¹⁸ See generally, Compliance Guide, *supra* note 15 at 87-91. For additional information regarding necessary disclosures related to projections of future performance, see *Id.* at 91-92 and 135-136.

¹¹⁹ FPR Commentary at 19.14.

¹²⁰ *Id.* 19.16 and 19.17.

weather conditions, urban or suburban environments, and other numerous factors.

Franchisors that make financial performance representations in Item 19 must provide written substantiation of the statement to prospective franchisees upon reasonable request, the precise determination of which is to be made based on all surrounding facts and circumstances associated with the request. A “supplemental representation” also may be warranted where the franchisor seeks to provide an FPR for a unique outlet for sale or for a type of outlet with abnormal characteristics (e.g., airport location). Supplemental representations must be written, state the reason the information differs from the stated performance level in Item 19, and comply with all requirements for making Item 19 disclosures generally.

Finally, while franchisors are required to include an “admonition” in Item 19 that warns prospective franchisees that their performance may differ from the stated level,¹²¹ a franchisor’s Item 19 may not be littered with numerous other disclaimers that negate a prospective franchisee’s ability to rely on the information presented. In fact, under the FPR Commentary, only one disclaimer is permitted, as follows:

- For historical representations – “Some [outlets] have [sold] [earned] this amount. Your individual results may differ. There is no assurance that you’ll [sell] [earn] as much.”
- For projections – “These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you’ll [sell] [earn] as much.”

21. Item 20: Outlets and Franchisee Information

Item 20 contains a detailed visual representation of how the franchise system has changed over the past three-year period. Included in Item 20 are five separate charts that provide detail related to the following: (1) system-wide outlet summary (franchised and company units, if applicable), (2) transfers, (3) status of franchised outlets (i.e., number of outlets at the beginning of the year, outlets opened, outlets terminated, outlets not renewed for additional term, outlets reacquired by the franchisor, outlets that ceased operations for other reasons, and total outlets at the end of the year), (4) status of company-owned outlets, and (5) projected openings (both franchised outlets and company outlets).¹²² Further, Item 20 captures contact information for current and former franchisees (usually appended as an exhibit to the FDD), as well as for franchisee associations.¹²³ In addition to franchisor-sponsored franchisee groups and councils, Item 20 discloses contact information for independent franchisee associations so long as the independent association is organized under state law and submits to the franchisor a written request for inclusion in the FDD within 60 days of the franchisor’s fiscal year end.¹²⁴ Finally, and in connection with the franchisor’s disclosure

¹²¹ *Id.* 19.3

¹²² 16 C.F.R. §436.5(t).

¹²³ 16 C.F.R. §436.5(t)(4) and (5).

¹²⁴ 16 C.F.R. §436.5(t)(8).

of former franchisee contact information, the Amended Rule requires that franchisors affirmatively disclose whether any former franchisees have signed confidentiality agreements restricting their ability to speak about the franchised business and their related experiences.¹²⁵

22. Item 21: Financial Statements

To help prospective franchisees gain a clearer picture of the franchisor's financial stability and wherewithal, Item 21 requires the franchisor's financial statements to be audited in accordance with United States generally accepted auditing standards ("GAAS") and to be presented in accordance with United States generally accepted accounting principles ("GAAP"). The financial statements must be presented in a tabular format that compares at least two fiscal years and includes: (1) the franchisor's balance sheet for the previous two fiscal year ends; and (2) statements of operations, stockholders equity, and cash flows for each of the franchisor's previous three fiscal years.¹²⁶ If the parent of the franchisor will commit to provide post-sale obligations of the franchisor or will guaranty its obligations, the audited financial statements of the parent (along with a manually-signed guaranty) must be included in Item 21 of the FDD.¹²⁷

Under the Amended Rule, franchisors that are new to franchising and do not yet have audited financial statements may phase-in the use of audited financials over a three-year period.¹²⁸ In such instance, the new franchisor would begin in year one with an "opening" unaudited balance sheet as of the date the franchisor commences franchising activities, followed by an audited balance sheet as of the end of the franchisor's first partial or full fiscal year selling franchises, in year two, and then another full suite of audited financials in year three.¹²⁹ Notably, the phase-in option is not allowed for the franchisor's affiliated entities or spin-offs; it is only permitted for unaffiliated entities that are completely new to franchising.¹³⁰

23. Item 22: Contracts

Item 22 contains a list of all contracts related to the franchise that the franchisor requires or for which the franchisor makes arrangements.¹³¹ For example, the form Franchise Agreement must be listed in the Item 22 list of contracts (and appended to the FDD as an exhibit), as that document must be signed by the franchisor and the prospective franchisee. Likewise, if the franchisor will sublease property to the franchisee for the franchised outlet, a copy of the franchisor's master lease and the sublease it plans to enter into with the franchisee must be referenced in Item 22 and appended to the FDD.

¹²⁵ 16 C.F.R. §436.5(t)(7).

¹²⁶ 16 C.F.R. §436.5(u).

¹²⁷ Compliance Guide, *supra note 15* at 114.

¹²⁸ 16 C.F.R. §436.5(u)(2).

¹²⁹ *Id.*

¹³⁰ Compliance Guide, *supra note 15* at 115.

¹³¹ 16 C.F.R. §436.5(v).

24. Item 23: Receipts

Item 23 is a summary disclosure related to the location of the FDD Receipt pages, however, the detail that appears on the Receipt pages is specific and must be adhered to closely. While the Receipt page is signed by the prospective franchisee and captures the date that they were disclosed with a specific FDD, it also informs the prospective franchisee of important information and rights under federal and state law.¹³² The Amended Rule also requires that the prospective franchisee identify all “franchise sellers” involved in the offer and sale of the franchise and places the burden on the franchisor for ensuring that the franchise seller is properly identified.¹³³

C. State-Specific Disclosure Requirements

The Amended Rule provides the minimum disclosure requirements that apply to all franchise offerings. However, certain states impose additional requirements, and if a franchisor desires to offer or sell franchises into a state that regulates franchising, the franchisor must comply with any additional state-specific disclosure requirements that apply to that offer or sale.

As a threshold matter, it is important to remember that the laws of more than one state may apply to a single offer and sale of a franchise. When considering which state laws may apply, franchisors must determine whether or not an “offer” or “sale” will be deemed to be made in a particular state. Although the laws of the various states differ, whether or not the events listed below occurred within the state are often key factors in making this determination.

- Meetings between the franchisor and prospective franchisee at which the parties have substantive communications about the franchise opportunity.
- The offer to sell a franchise originates in the state (e.g., from the franchisor’s headquarters in the state).¹³⁴
- The offer to sell a franchise is directed by the franchisor to the state and received by the prospective franchisee in the state where it is directed.
- The prospective franchisee accepts the offer to buy the franchise in the state.

¹³² 16 C.F.R. §436.5(w).

¹³³ Compliance Guide, *supra note 15* at 118.

¹³⁴ California, Hawaii, Illinois, Maryland, Michigan, Minnesota, Rhode Island, South Dakota, Virginia and Wisconsin each provide an exemption from registration for, or simply do not cover, “out-of-state” sales. These are sales made by a franchisor headquartered in one of these registration states to an out-of-state prospective franchisee who neither resides nor will operate the franchise business in the same state as the franchisor’s headquarters. The out-of-state sales exemption allows a franchisor to have its principal place of business in a registration state without having to register to sell franchises there as long as: (1) all sales activities are with a non-resident who will operate franchises in a different state, and (2) the franchisor complies with the Amended Rule and all other state franchise sales laws that apply to the transaction.

- The offer or sale is made to a franchisee who is domiciled in the state. Under some state laws, the franchisee's domicile in the state is enough. Under other state laws, the franchisee must be a domiciliary and operate the franchise business in the state.
- The offer or sale is made to a franchisee who resides in the state. Like domicile, in some states the franchisee's residence in the state is enough; in other states the franchisee must be a resident and operate the franchise business in the state.
- The franchise business will be operated in the state or any portion of the franchise territory is in the state.
- The franchise contemplates or requires the franchisee to establish or maintain a place of business in the state.

In addition to complying with the state-specific disclosure requirements described below in this Section II.C., a franchisor must also ensure that its sales activities do not inadvertently cause the state franchise laws to apply in a state where the franchisor is not registered. The registration requirements for the various states are addressed below in Section III.

1. Examples of Additional State-Specific Disclosures

This Section II.C.1 summarizes some common additional state-specific disclosures.

a. Item 1: Laws & Regulations

As noted in Section II.B.2 above, the Amended Rule requires franchisors to summarize for prospective franchisees any laws and regulations applicable to the franchised business. While there are a number of federal laws that apply to businesses generally that a franchisor will reference in its Item 1 disclosure, depending on the nature of the franchised business and the states in which the franchise will be offered, additional state-specific laws, regulations and/or licensing requirements may need to be disclosed. For example, health care franchisors typically disclose the existence of state or local health care related laws, regulations and licensure requirements in Item 1. Similarly, franchisors in the home improvement or construction industry often disclose state-specific requirements for contractor's licenses and bonds. Restaurant franchisors may also need to disclose state-specific food safety, menu labeling, licensing and other similar requirements.

b. Item 4: Bankruptcy

As noted in Section II.B.5 above, the Amended Rule requires franchisors to disclose bankruptcy and related proceedings that have occurred in the prior ten years. Minnesota, however, requires an additional bankruptcy disclosure. Under Minnesota law, the bankruptcy disclosure is 15 years – five years longer than the required

Amended Rule.¹³⁵ The unknowing franchisor who deletes a bankruptcy disclosure after ten years will be opening itself up to liability from those Minnesota franchisees who purchased franchises during the five year period after deletion of the disclosure.

c. Item 8: Rebates

As summarized in Section II.B.9 above, the Amended Rule requires a franchisor to make certain disclosures related to any obligatory purchases, sourcing restrictions, and rebates received from suppliers. The Maryland regulations require franchisors to take these disclosures a few steps further. Specifically, the Maryland regulations require the following additional detail: (1) a disclosure of any affiliation between the franchisor and these sources of supply; (2) if the source is affiliated with the franchisor, the cost to the seller of the items; (3) the prevailing market price for the goods, and if none exists, an explanation as to why market price cannot be determined; and (4) the manner, if any, in which the franchisor or its affiliate under the terms of the franchise agreement ensures the availability of the goods.¹³⁶

d. Item 11: Advertising

In addition to the Item 11 advertising fund disclosures required under the Amended Rule, the Maryland regulations also require franchisors to disclose: (1) how fees related to advertising are to be raised or spent; and (2) how a franchisee may obtain an accounting of the advertising expenditures.¹³⁷

e. Item 21: Financial Statements

As discussed in Section II.A.22 above, the Amended Rule permits franchisors that are new to franchising to “phase-in” the use of audited financial statements over a three-year period, and specifically allows for the use of an unaudited opening balance sheet during year one. The use of an unaudited opening balance sheet to satisfy the Item 21 disclosure requirement is not, however, permissible under certain state franchise acts. Specifically, the states of Minnesota, New York and Virginia require that a franchisor have its opening balance sheet audited by a certified public accountant.¹³⁸

2. State Cover Page and Risk Factors

As noted above, various state laws and state administrators may require additional disclosures be included in the FDD. These disclosures can be presented in the body of the FDD or in an addendum to the FDD.¹³⁹ State administrators often request that a franchisor include certain state-specific risk factors into a “State Cover Page” that is typically included immediately after the federal cover page discussed above in Section II.B.1. Typically, the inclusion of particular risk factors is based upon:

¹³⁵ Minn. R. 2860.3500(4)(D).

¹³⁶ Md. Code Regs. 02.02.08.16(J).

¹³⁷ Md. Code Regs. 02.02.08.16(G).

¹³⁸ Minn. Stat. Ann. § 80C.04; N.Y. Comp. Codes R. & Regs. tit. 13, § 200.2; 21 Va. Admin. Code 5-110-55.

¹³⁹ Compliance Guide, p. 26.

(1) the state in which the franchise is being offered, (2) the dispute resolution provision selected by the franchisor, (3) whether minimum performance obligations are imposed, (4) whether any conditions are imposed on the owner's spouse, and (5) the financial condition and experience of the franchisor. Unfortunately, state administrators have not adopted uniform risk factors or a uniform approach for when a particular risk factor will be required. Franchisors should not include any risk factor that is not required by the FTC Rule, state law or a state administrator. An example of a set of risk factors commonly imposed by state administrators is attached as Exhibit D.

3. State Addenda

As discussed above, every franchisor must comply with the specific disclosure requirements of each state the franchisor wishes to offer or sell franchises. However, this does not mean, the franchisor must prepare a separate, state-specific FDD to address the requirements of each state. Instead, most franchisors prepare state-specific addenda to address: (1) disclosures required to advise prospects of that state's limited review of the franchisor's FDD; and (2) modifications to the FDD (and to related agreements) that are necessary to (a) notify the franchisee of its rights under that state's franchise relationship laws such as the franchisee's rights in connection with termination and non-renewal of the franchise agreement, (b) preserve the franchisee's rights under state law from waiver or modification by the terms of the franchise or other agreement and (c) disclose any financial assurances the franchisor is required to provide as a condition of registration due to the franchisor's financial condition and/or years of franchising experience.¹⁴⁰

Examples of state addenda are attached as Exhibit E. Certain states also require changes to be made to the basic terms of the franchise agreement or other agreements between the franchisor and franchisee, and most franchisors prepare specific state addenda modifying the terms of these agreements. However, since the specific terms of these agreements can vary significantly, examples of state addenda to franchise agreements and other agreements are not attached to this paper.

4. State-Specific Timing Requirements

In addition to the state-specific disclosure issues described above, Iowa, Michigan and New York impose different timing requirements for the franchisor to provide its FDD to prospects. Instead of following the timing requirements in the Amended Rule (i.e fourteen (14) calendar days), Iowa and New York require that the franchisor deliver the FDD on the earlier of (a) the "first personal meeting" with the prospective franchisee or (b) at least ten (10) business days in New York (or fourteen

¹⁴⁰ Depending on the franchisor's financial condition and years of franchise experience, a state may require a franchisor to provide financial assurances as a condition of registration. The specific financial assurance required varies by state, but typically a franchisor may satisfy the financial assurance by doing one of the following: (1) deferring collection of the initial franchise fee (or other initial fees) until the franchisor satisfies its pre-opening obligations and the franchisee commences operation, (2) escrowing payment of the initial fees, (3) posting of a surety bond, or (4) providing a guaranty of the franchisor's obligations to its franchisees from a parent or affiliate of the franchisor and attaching a copy of the audited financial statements of the guarantor to the FDD.

(14) calendar days in Iowa) before the date the prospect signs a binding agreement or pays any money.¹⁴¹ Michigan requires that the franchisor deliver the FDD at least ten (10) business days before the date the prospect signs a binding agreement or pays any money.¹⁴²

III. Securing State Franchise Registration

As mentioned above, the Amended Rule is a disclosure-only rule. There is no federal franchise registration requirement imposed by the Amended Rule. However, fourteen (14) states impose some form of registration obligation on a franchisor. The state registration (or state approval of a franchise registration) by a state regulator essentially grants the franchisor the right to offer and sell franchises within that state. Registration is on a state-by-state basis, and a franchisor is only required to comply with a state registration requirement if an “offer” or “sale” will be deemed to be made in that state using the principles described above in Section II.C.

Franchise regulators do not review FDDs filed by franchisors to test the soundness of the franchise offer, but instead to confirm whether or not the FDD addresses the disclosure requirements of the NASAA 2008 Registration and Disclosure Guidelines. By enforcing these requirements, state regulators aim to ensure that franchise prospects can compare franchise opportunities on an “apples-to-apples” basis. However, there is no central clearance system for processing franchise registration applications.

A. State Registration Filing Requirements

Similar to the state-specific disclosure obligations, the state registration requirements differ from state to state. Most state regulators require that the franchisor submit its FDD along with various other standardized forms and documents. Franchisors also must provide specific information about any individual who sells franchises on the franchisor’s behalf. Each state also has specific documentation requirements depending upon whether the filing is an initial registration, a renewal of an existing registration, an amendment to an existing application or an application for an exemption to the state’s franchise laws. Finally, the method by which a franchisor submits its franchise application varies by state. Some states permit online filing, some states mandate online filing, and other states require paper filings and/or submissions on electronic media such as CD-ROM. Exhibit F summarizes the state-specific requirements to file an application for an initial franchise registration in each state that requires registration. The requirements in connection with renewals, amendments or applications for exemptions may differ from Exhibit F depending on the state.

B. State Examiner Review Process and Comment Letters

Most state franchise acts provide a limited period of time during which a state franchise administrator must approve or deny a franchise application. These rules

¹⁴¹ Iowa Code Ann. § 551A.4; N.Y. Gen. Bus. Law § 683(8)(a).

¹⁴² Mich. Comp. Laws Ann. §445.1508.

generally provide that a FDD will be automatically registered when the statutory period expires unless: (1) the administrator has issued a stop order or obtained an injunction barring the registration, or (2) the administrator has issued a comment or deficiency letter to the applicant describing the corrections or additional disclosure the franchisor must make to effect registration. The degree of scrutiny devoted to a franchise application varies significantly from state to state but can generally be divided into two distinct types: (a) full review states and (b) notice filing states.

Full review states are states in which the FDD and franchise application are subject to full review by a state administrator before a decision is made by the state whether or not to approve the franchisor's registration and include the following states: California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia and Washington. A franchise examiner's response to an application for registration in a full review state often takes the form of a comment letter or a deficiency letter addressed to the franchisor who submitted the application. The franchise administrator often requests additional information be provided by the franchisor and/or revisions be made to the franchisor's FDD. State administrators may issue subsequent comment letters until all matters are resolved.

Notice filing states are states in which the franchise registration application is deemed registered, by statute, when the state receives all required information and include the following states: Indiana, Michigan and Wisconsin. While administrators in these states have the authority to review the documents filed with the state and issue comments, they seldom, if ever do.

In addition to the states that require registration, there are five business opportunity states that require a franchisor to file a simple notice with a state agency in order to qualify for an exemption from the state's business opportunity law and include the following states: Florida, Kentucky, Nebraska, Texas and Utah. The frequency with which the notice of exemption must be filed varies by state. Florida and Utah require an annual notice of exemption be filed each year, but Kentucky, Nebraska and Texas only require a one-time exemption filing.¹⁴³

C. Strategies for Managing the Registration Process

Below are some best practice tips for expediting the franchise registration process:

¹⁴³ In other business opportunity law states, exemption from the definition of a "business opportunity" depends on the franchisor awarding a license to the franchisee to use a federally (or state) registered mark as part of the franchised business, or offering a franchise in compliance with the Amended Rule. If a franchisor does not satisfy the conditions for exemption from the state business opportunity law, the franchisor will be deemed to be a "business opportunity seller" and must comply with all business opportunity pre-sale disclosure and registration requirements – which requirements are comparable to, though less complex than, the franchise registration process. This issue most frequently arises for a new franchisor that has not yet obtained a federal registration for its principal trademark. Business Opportunity Law compliance is outside the scope of this paper. See, Beata Krakus, Alexander Tuneski, *Caught in the Web of Federal & State Business Opportunity Laws: Managing & Avoiding the Entanglement of Regulations*, 36th Annual ABA Forum on Franchising (2013) for more information.

- Ensure the FDD is compliant with the Amended Rule by using the drafting tips and tools described in Section II.A;
- Make the FDD compliant with applicable state law by reviewing each state's individual state laws, regulations, guidelines and commentary;
- Comply with all state filing requirements in Exhibit F for initial registrations and use any forms prescribed by a particular state;
- 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;
- 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;
- Contact the state administrator about any comment included in a comment or deficiency letter with which the franchisor disagrees or that is unclear;
- 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; and
- 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.

During the franchise registration process, a franchisor (or its counsel) should maintain a current "state status summary" detailing the franchise registration status in each state. The state status summary should be regularly shared with all franchise sellers to ensure that they have an accurate resource that they can consult before engaging in sales activities. The state status summary should include whether or not the FDD has been registered in a particular state as well as any other state-specific requirements for that state such as any requirement that the franchisor defer or escrow the collection of the initial fees until the franchisee opens for business.

IV. Franchise Amendment and Renewal Requirements

A franchisor must ensure that its FDD is accurate and up to date at all times. To that end, the Amended Rule imposes three basic updating requirements: (1) annual updates, (2) quarterly updates, and (3) notification of changes in financial performance information. Similarly, Registration States require franchisors to renew their franchise

registration on a yearly basis, and impose an amendment obligation upon the occurrence of a material change.

A. When is an Amendment Necessary

1. Federal Requirements

The Amended Rule imposes a quarterly updating requirement. Specifically, within a reasonable time after the close of each fiscal quarter, a franchisor must prepare and include in Item 22 an attachment to its FDD reflecting any material change to a franchisor's FDD.¹⁴⁴ Determining whether an amendment is necessary requires an analysis of whether there has been a "material change" to any of the information presented in the FDD. According to the Compliance Guide, material changes include events such as bankruptcy filings and the filing of legal actions against the franchisor that could negatively impact the franchisor's financial condition.¹⁴⁵ Despite this, certain FDD disclosure requirements require only annual updating. For example, the franchisor-initiated litigation disclosures in Item 3 must be updated only once a year. Likewise, the statistical information about franchised outlets required by Item 20 as well as the franchisee lists need only be revised on an annual basis. In addition, any financial information required to be audited need not be re-audited for a quarterly update, unless there is a material change affecting the previously audited financial information – and, in that event, a franchisor may furnish unaudited information in the quarterly update.¹⁴⁶

One key exception to the federal quarterly update requirement is if the update relates to any financial performance information contained in Item 19 of the FDD. The Amended Rule requires that, when furnishing a disclosure document, franchise sellers notify the prospective franchisee of any material changes that the seller knows or should have known occurred with respect to any financial performance representation made in Item 19.¹⁴⁷

2. State Requirements

Certain states also require a franchisor to update the FDD in response to material changes in the system. In many instances, the timeframe to update the FDD in the event of a material change at the state level is much shorter than the quarterly requirement set forth in the Amended Rule. For example, in California, Maryland, Michigan, New York, North Dakota and Rhode Island, a franchisor must "promptly" file an amendment when a material changes occurs.¹⁴⁸ In Hawaii, Virginia and Washington, a franchisor must amend upon the occurrence of a material change.¹⁴⁹ In Minnesota and Wisconsin, a franchisor must amend within 30 days of a material

¹⁴⁴ 16 C.F.R. §436.7(b).

¹⁴⁵ Compliance Guide, *supra note 15* at 126.

¹⁴⁶ *Id.*

¹⁴⁷ 16 C.F.R. §436.7(d).

¹⁴⁸ Cal. Corp. Code § 31123, Md. Code Ann., Bus. Reg. § 14-220, Mich. Comp. Laws Ann. § 445.1519, N.Y. Gen. Bus. Law § 683, N.D. Cent. Code Ann. § 51-19-07, 19 R.I. Gen. Laws Ann. § 19-28.1-11.

¹⁴⁹ Haw. Rev. Stat. Ann. § 482E-3, 21, Va. Admin. Code 5-110-40, Wash. Rev. Code Ann. § 19.100.070.

change.¹⁵⁰ Illinois and South Dakota are more closely aligned with the Amended Rule and require franchisors to prepare and file amendments after the end of each fiscal quarter to reflect any material changes.¹⁵¹ In Indiana, a franchisor does not need to file an amendment for a material change unless requested by the state, however, a franchisor can voluntarily amend at any time to reflect any post-effective amendments to the FDD.¹⁵² Since the state laws vary in terms of the required timing to file an amendment, franchisors are wise to put procedures in place to identify potential material changes and then amend its FDD in short order to comply with the state law amendment requirements.

B. Annual Renewal Requirements

In addition to the quarterly update requirement under the Amended Rule (or earlier amendment obligation under state law), both federal and state law obligate franchisors to update their FDDs on an annual basis. This annual update commonly is referred to as the “renewal” process. The annual renewal requirement under both the Amended Rule and state laws are discussed further in this Section IV.B below.

1. Federal Requirements

The Amended Rule requires a franchisor to update the information in the FDD each year within 120 days after its fiscal year end.¹⁵³ After the 120-day period has expired, franchisors may only use the updated FDD and must discontinue the franchise sales process until the updates have been completed. While amendments to the FDD can be made throughout the year, most franchisors incorporate new system changes as part of the annual renewal process. At a minimum, during the annual renewal process a franchisor must revise its FDD to include new audited financial statements, update the Item 20 charts and list of franchises, and update any other disclosures that describe the status of the franchisor or franchised business over the prior fiscal year.

2. State Requirements

As with the Amended Rule, the Registration States require a franchisor to update the FDD and franchise registration each year. Depending on the state, the annual renewal filing must be made within 90 to 120 days following the end of the franchisor’s fiscal year, or prior to the anniversary of the effective date of the previous franchise registration. If the state requires the renewal filing based on the anniversary date of the previous year’s franchise registration, the state generally requires that the renewal filing be made within 15 to 30 days before the previous year’s registration expires. The period of time between the filing of the renewal application and the date of effectiveness of the renewal filing varies by state. This is not a long period in Illinois, Indiana, Michigan, South Dakota and Wisconsin, as a renewal application is deemed effective upon receipt. In Hawaii, a renewal application is deemed effective seven days after

¹⁵⁰ Minn. Stat. Ann. § 80C.07, Wis. Stat. Ann. § 553.31.

¹⁵¹ 815 Ill. Comp. Stat. Ann. 705/11, S.D. Codified Laws § 37-5B-7.

¹⁵² Ind. Office of the Sec’y of State Secs. Div., *Order Regarding Franchise Registrations by Notification*, Order No. 01-0109 AO, Bus. Franchise Guide (CCH) ¶ 5,140.012 (June 4, 2001).

¹⁵³ 16 C.F.R. §436.7(a).

receipt. If the renewal application is not filed in a timely fashion, the franchisor's registration will lapse, all sales activity in the state must cease, and the franchisor must once again file an initial franchise registration application with the state.

C. Permitted Activities While Renewal or Amendment Applications are Pending

Generally, the most conservative approach for a franchisor is to cease sales while its renewal and amendment applications are pending with the registration states. However, in certain states, the registration laws provide specific guidance as to how sales activity can continue during this period. For example, New York allows franchisors to continue sales activity if the franchisor advises the prospective franchisee that an amendment is pending, provides the prospective franchisee with a copy of the old disclosure document along with a disclaimer that the amendment is pending, and escrows any fees received from the prospective franchisee. The franchisee then has 10 business days to rescind the transaction after it receives the approved amended FDD from the franchisor.¹⁵⁴ A similar process exists in California, where the franchisor can provide a prospective franchisee with the pending FDD, along with a disclaimer that it is not registered. The franchisor must then redeliver the updated FDD once it is approved along with a blackline showing any changes, and wait an additional 10- days before the franchisee signs the franchise agreement or pays any fees. While California's process does not permit the franchisor to proceed with the sale of a franchise and collect a franchise fee, the process allows the franchisor to continue to engage the prospective franchisee while its renewal and amendment applications are pending.¹⁵⁵ In Rhode Island, a franchisor can provide the pending FDD to a prospective franchisee before the FDD is approved, so long as after it is approved, the franchisor provides the prospective franchisee with a blackline showing any changes and waits an additional 10 business days before closing the sale with the approved FDD.¹⁵⁶

Once the franchisor completes and issues its updated FDD, the franchisor must cease using the old FDD and all new prospective franchisees who were not previously disclosed with the old FDD must receive the new FDD. Under the Amended Rule, the franchisor is not technically required to furnish an updated FDD to a prospective franchisee that it has already disclosed with the old FDD, unless the prospective franchisee makes a "reasonable request" for the updated FDD. However, best practices dictate that the franchisor should re-disclose all pending prospective franchisees and wait an additional 14 calendar days (or longer time required by state law) before accepting any fees or a signed binding agreement.

V. Navigating Franchise Exemptions

If a business relationship constitutes a franchise under either federal or state law, a franchisor is required to comply with the disclosure requirements (and, if applicable, the state registration requirements) summarized above unless the transaction (or one of

¹⁵⁴ 13 Codes, Rules and Regulations of the State of New York, §200.3(h)(3).

¹⁵⁵ Cal. Corp. Code §31107.

¹⁵⁶ 19 R.I. Gen. Laws. Ann. §19-28.1-6(10).

the parties involved in the transaction) satisfies one or more exemptions from those requirements. The exemptions from the federal disclosure requirements under the Amended Rule are different from the exemptions available under various state franchise laws. In addition, even when a franchise sale is exempt from the disclosure requirements under the Amended Rule, the franchise sale may still be subject to the disclosure and/or registration requirements of one or more state franchise laws. When this occurs, a franchisor must ensure that the transaction (or one of the parties involved in the transaction) also satisfies an exemption from the applicable state franchise laws. Finally, some state exemptions only relieve a franchisor from the state's registration requirements and the franchisor is still required to meet the disclosure requirements. In short, franchisors must be careful when navigating the maze of franchise exemptions at both the federal and state levels.

A. FTC Franchise Rule Exemptions

There are a number of exemptions available from the disclosure requirements under the Amended Rule, and Exhibit G to this paper includes a list of the available federal exemptions. If the transaction qualifies for an exemption under the Amended Rule, the franchisor is not required to comply with the pre-sale disclosure requirements of the Amended Rule.¹⁵⁷ While a detailed analysis of all of the exemptions available is beyond the scope of this paper, we have summarized four of the most commonly used exemptions under the Amended Rule.¹⁵⁸

1. Fractional Franchise Exemption

A “fractional franchise” is generally an extension of, or add-on to, a product or service the franchisee is already offering to the public. Fractional franchises are common in grocery stores, convenience stores or other similar locations where the product or service offered is “in-line” with another business.¹⁵⁹ In order to qualify for this exemption, the relationship between the franchisor and franchisee must satisfy the following two criteria: (1) the franchisee, any of its current directors or officers, or any current directors or officers of a parent or affiliate, has more than two years of experience in the same type of business as the franchise being offered or sold; and (2) the parties to the transaction have a reasonable basis to anticipate that the sales arising from the relationship will not exceed 20% of the franchisee's total dollar volume in sales during the first year of operation.¹⁶⁰

Under the Amended Rule, “same type of business” means selling competitive goods or being in a business that would ordinarily be expected to sell the type of goods to be offered by the franchised business.¹⁶¹ The Compliance Guide provides the example of an independent ice cream store owner. Most likely an independent ice

¹⁵⁷ 16 C.F.R. §436.8.

¹⁵⁸ See Alan R. Greenfield, Theresa Leets, and Karen B. Satterlee, *Franchise Disclosure Challenges for Large, Sophisticated, or Multi-Brand Franchise Companies*, 37th Annual ABA Forum on Franchising (2014), for a detailed discussion of the applicable federal and state franchise law exemptions.

¹⁵⁹ *Id.*

¹⁶⁰ 16 C.F.R. §436.1(g).

¹⁶¹ Compliance Guide, *supra note 15* at 8.

cream store owner will qualify as a fractional franchisee if he or she were to enter into a franchise relationship with an ice cream cake supplier, but would not qualify if the franchise relationship expanded the store's product line to include items not typically found in ice cream stores, like greeting cards.¹⁶²

With respect to the second condition, sales volume may include sales resulting from multiple locations operated by the franchisee. For example, the parties may compare sales resulting from the fractional franchise against total sales at all stores owned by the franchisee (franchised or non-franchised).¹⁶³ According to the Compliance Guide, an individual owning several hardware stores may introduce a new product at only one store and measure the increase in sales attributed to the new product against the aggregate total sales volume for all products sold through his or her business.¹⁶⁴

2. Minimal Franchise Fee Exemption

If the total amount of the payments required to be made by a franchisee to the franchisor (or any of its affiliates) at any time within the first six months of commencing operations are less than \$570, then the franchise sale is exempt from the disclosure requirements of the Amended Rule.¹⁶⁵ For purposes of this exemption, a franchisee commences operation when it first makes goods or services available for sale in its business. This exemption is useful for franchisors that are willing to defer the payment of fees for a period of six months in order to avoid the expense of preparing a FDD. One way to structure a franchise program to take advantage of this exemption is to have the franchisee sign a non-negotiable promissory note that is due after the expiration of the six-month period.¹⁶⁶

3. Large Franchisee Exemption

Another exemption available under the Amended Rule is the large franchisee exemption. Under this exemption, a franchise relationship is exempt from the federal disclosure rules when the franchisee (or any of its affiliates) has at least five years of prior business experience and has a net worth of at least \$5,715,500.¹⁶⁷ This exemption applies to both business entities and individuals.¹⁶⁸ The prior experience need not be in franchising or even in the same industry as the franchised business.¹⁶⁹ The prior experience and net worth of the prospective franchisee's affiliates and parents

¹⁶² *Id.*

¹⁶³ *Id.* at 8-9.

¹⁶⁴ Compliance Guide, *supra* note 15 at 9.

¹⁶⁵ 16 C.F.R. §436.8(a)(1). The Commission is required to adjust the threshold for the minimum payment exemption every four years to account for inflation. The Commission adjusted the minimum payment threshold to \$570, effective July 1, 2016. See, "FTC Adjusts Monetary Thresholds for Three Exemptions in Franchise Rule," *supra* note 6.

¹⁶⁶ Compliance Guide, *supra* note 15 at 7.

¹⁶⁷ 16 C.F.R. § 436.8(a)(5)(ii). As with the minimum franchise fee exemption, the Commission adjusted the minimum net worth requirement to \$5,715,500, effective July 1, 2016. See, "FTC Adjusts Monetary Thresholds for Three Exemptions in Franchise Rule," *supra* note 6.

¹⁶⁸ 72 Fed. Reg. 15,527

¹⁶⁹ Compliance Guide, *supra* note 15 at 13.

may also be considered in determining whether or not the exemption criteria have been met.¹⁷⁰ This is arguably the most useful exemption due to the ability of the franchisor to tack on the business experience of affiliates and consolidate their collective net worth.¹⁷¹

4. Large Investment Exemption

The large investment exemption is satisfied when the franchisee's initial investment equals or exceeds \$1,143,100, and the prospective franchisee signs an acknowledgment verifying the amount of the investment.¹⁷² In measuring the initial investment, any financing received from the franchisor (or one of its affiliates) and the cost of unimproved land must be excluded. The franchisee acknowledgment must include the following specific language:

The franchise sale is for more than \$1,143,100 – excluding the cost of unimproved land and any financing received from the franchisor or an affiliate – and thus is exempted from the Federal Trade Commission's Franchise Rule disclosure requirements, pursuant to 16 CFR 436.8(a)(5)(i).¹⁷³

In determining whether the investment threshold has been met, the types of expenses typically included in Item 7 of the FDD are the only expenses that can be considered.¹⁷⁴ In addition, potential future payments which may be made over the life of the franchise relationship must be excluded.¹⁷⁵

Often one of the biggest obstacles to satisfying this exemption is that at least one individual must invest at the minimum threshold level for the exemption to apply.¹⁷⁶ The large investment exemption is premised on the assumption that a franchisee's sophistication goes hand-in-hand with the franchisee's ability to invest a large sum in the franchise opportunity. This assumption fails when no one person, standing alone, satisfies the investment threshold.¹⁷⁷ For purposes of meeting the threshold, a husband and wife are considered one individual.¹⁷⁸

5. Other Exemptions

In addition to the federal exemptions outlined above, the Amended Rule recognizes the following exemptions: (1) leased department, (2) insider exemption, (3) franchise relationships covered by the Petroleum Marketing Practice Act, or (4) where

¹⁷⁰ *Id.*

¹⁷¹ *Franchise Disclosure Challenges for Large, Sophisticated, or Multi-Brand Franchise Companies* at 4.

¹⁷² 16 C.F.R. § 436.8(a)(5)(i). The Commission adjusted the large investment threshold to reflect \$1,143,100, effective July 1, 2016. See, "FTC Adjusts Monetary Thresholds for Three Exemptions in Franchise Rule," *supra* note 6.

¹⁷³ 16 C.F.R. §436.8(a)(5)(i).

¹⁷⁴ Compliance Guide, *supra* note 15 at 10.

¹⁷⁵ Compliance Guide, *supra* note 15 at 10.

¹⁷⁶ *Id.*

¹⁷⁷ *Id.* at 12.

¹⁷⁸ *Id.*

there exists no written document that describes any material term or aspect of the relationship or arrangement.¹⁷⁹ Due to the relative infrequency that these exemptions are used in comparison to the exemptions described above, this paper does not address the criteria for meeting these exemptions.

B. State Exemptions

As noted above, franchisors that wish to avail themselves of an exemption must recognize that, not only must a federal exemption be satisfied, but also the elements of a state exemption must be satisfied. As summarized below and in Exhibit G attached to this paper, not all federal exemptions are available at the state level and often the exemption requirements differ. Further, for practitioners advising franchise clients on the applicability of state law exemptions, it is critical to understand the scope of a particular state exemption to determine whether exemption is from both the state's disclosure and registration obligations. Often, the exemption is from the state registration requirement only, thus requiring a franchisor to still comply with any state-mandated disclosure obligation.

1. Large Franchisor Exemption

While perhaps the most commonly used state exemption, the large franchisor exemption is not available under the Amended Rule and exempts a qualifying franchisor from certain state registration obligations only. The states that currently recognize the large franchisor (or the "net worth" or "seasoned franchisor") exemption include: California, Illinois, Indiana, Maryland, New York, North Dakota, Rhode Island, Virginia and Washington. While the precise requirements of this exemption vary by state, generally the large franchisor exemption requires a certain level of experience and net worth. Typically, the franchisor or parent of the franchisor must have a minimum of five years of experience, at least 25 franchisees in the same business as offered, and a minimum net worth ranging from \$5 million to \$15 million. While the state large franchisor exemption exempts qualifying franchisors from the state registration requirements, each state still requires the franchisor to comply with the state pre-sale disclosure requirement. As a result, franchisors that qualify for the large franchisor exemption still must prepare an FDD and comply with all pre-sale disclosure obligations.

2. Large Franchisee Exemption

Similar to the Amended Rule's large franchisee exemption, six states have a large franchisee exemption.¹⁸⁰ Satisfaction of a state large franchisee exemption is based on two criteria: (1) the experience of the prospective franchisee or its underlying owners, and (2) the prospective franchisee's net worth. For example, under the Illinois Franchise Act, a franchise offering is exempt from the state registration requirement if: (1) the franchisee (or a parent of franchisee) has been in business for at least five years, and (2) the franchisee (or a parent of franchisee) has a net worth of at least \$5

¹⁷⁹ See, 16 C.F.R. §436.8(a)(3), (4), (6), and (7).

¹⁸⁰ California, Illinois, Rhode Island, South Dakota, Virginia, and Washington.

million.¹⁸¹ As with all state exemptions, the precise requirements needed to satisfy the exemption varies from state to state, as does the scope of the exemption.

3. Fractional Franchise Exemption

A number of states provide a fractional franchise exemption similar to the Amended Rule.¹⁸² Similar to the federal exemption, the state fractional franchise exemptions hinge on the experience of the prospective franchisee and the anticipated gross sales of the franchised business. For example, the Minnesota fractional franchise exemption requires that: (1) the franchisee has a minimum of two years of experience in the same type of business, and (2) the parties anticipate (or should anticipate) that the sales from the franchised business will not exceed 20% of the franchisee's total sales.¹⁸³

4. Other Exemptions

In addition to the exemptions identified above, other state exemptions include: (1) large investment exemption, (2) insider exemption, (3) institutional franchisee exemption, (4) single franchise exemption, (5) nominal fee exemption, (6) sale by judicial officer exemption, (7) sale by existing franchisee exemption, (8) exemption by order, (9) leased department exemption, (10) securities exemption, (11) out-of-state exemption, and (12) exemption for renewal, extension, amendment or modification of agreement. The states that provide for each of the exemptions listed above are noted in Exhibit G attached to this paper.

VI. Additional Filing Requirements Beyond the FDD

A. Advertising Registration Requirements

In addition to the franchise (FDD) registration obligations required by the Registration States, the following states also require the filing of franchise sales advertising materials before use: California, Maryland, Minnesota, New York, North Dakota and Washington. The advertising registration requirements imposed by each of these states are summarized in the attached Exhibit H. An advertisement is generally deemed approved by a particular state if no comments are received within a specified number of days from the date the advertisement is received by the state. Submission or filing of advertisements is generally not required outside of the states identified above.

The proliferation of the internet as a promotional tool has confronted franchisors with the challenge of determining how traditional advertising rules (including the advertising registration requirements noted above) apply to this invaluable communications medium. Given this reality, several states have adopted an exemption process for web-based franchise sales advertisements. In general, internet-based franchise sales advertising is exempt from statutory registration requirements if each of

¹⁸¹ 815 Ill. Comp. Stat. 705/8(2).

¹⁸² California, Illinois, Indiana, Michigan, Minnesota, New York, Oregon, South Dakota, Virginia and Wisconsin.

¹⁸³ Minn. Stat. Ann. § 80C.03(f); 80C.01(18).

the following requirements are met: (1) the advertisement states that the offer is not directed to residents of the state, (2) the advertisement is not actually directed to any resident of the state, and (3) no franchises are sold in the state until the franchisor obtains state registration.¹⁸⁴ To account for the state internet exemptions noted above, franchisors should ensure that their websites contain disclaimers that are drafted to take advantage of these internet exemptions. For example, the franchise sales portion of a franchisor's website should prominently display words such as the following:

This website and the franchise sales information on this site do not constitute an offer to sell a franchise. The offer of a franchise can only be made through the delivery of a franchise disclosure document. Certain states require that we register the franchise disclosure document in those states. The communications on this website are not directed by us to the residents of any of those states. Moreover, we will not offer or sell franchises in those states until we have registered the franchise (or obtained an applicable exemption from registration) and delivered the franchise disclosure document to the prospective franchisee in compliance with applicable law.

Of course, a franchisor must ensure that its actual internet practices are consistent with any disclaimer published by the franchisor on its website.

B. Franchise Seller / Broker Requirements

A final state registration requirement of which franchisors should be aware relates to any franchise sellers and/or brokers used by a franchisor in connection with the franchise sales process. Under the Amended Rule, a "franchise seller" is a person that offers, sells or arranges for the sale of a franchise.¹⁸⁵ This includes the franchisor and its employees, agents, area representatives, subfranchisors and third-party brokers, but does not include existing franchisees.

With the exception of South Dakota, Virginia and Wisconsin, all other Registration States require a franchisor to file a franchise seller disclosure form for each of its "franchise sellers" in connection with a franchisor's initial or renewal franchise application process. (See, Exhibit E to this paper for more information.) The franchise seller disclosure form includes the franchise seller's previous five years of employment history, and discloses whether the franchise seller has been named in certain litigation or arbitration actions during the prior ten years. In addition to filing the franchise seller disclosure forms, two states –New York and Washington – require third party brokers to register with the state as an authorized broker of the franchise system prior to engaging in any sales activities in the state.¹⁸⁶ As a franchisor authorizing the broker to sell its franchise, the franchisor should ensure that all broker registration requirements have been satisfied.

¹⁸⁴ Bus. Franchise Guide (CCH) ¶ 5,230.81 (Dec. 4, 2002).

¹⁸⁵ 16 C.F.R. §436.1(j).

¹⁸⁶ Wash. Rev. Code Ann. § 19,100.140.

VII. Conclusion

The laws and regulations that govern the offer and sale of franchises in the U.S. are complex, and the information provided in this paper is just the tip of the iceberg. Franchisors (and their counsel) must understand these laws and regulations and the details of the various aspects (including operational and financial) of the franchise business in order to ensure that the franchisor complies with all of the applicable disclosure and registration requirements.

Exhibit A

Sample Item 9 Table

	Obligation	Section in Agreement	Disclosure Document Item
a.	Site selection and acquisition/lease		
b.	Pre-opening purchases/lease		
c.	Site development and other pre-opening requirements		
d.	Initial and ongoing training		
e.	Opening		
f.	Fees		
g.	Compliance with standards and policies/Operating Manual		
h.	Trademarks and proprietary information		
i.	Restrictions on products/services offered		
j.	Warranty and customer service requirements		
k.	Territorial development and sales quotas		
l.	Ongoing product/service purchases		
m.	Maintenance, appearance and remodeling requirements		
n.	Insurance		
o.	Advertising		
p.	Indemnification		
q.	Owner's participation/ management/staffing		
r.	Records and reports		
s.	Inspections and audits		
t.	Transfer		
u.	Renewal		
v.	Post-termination obligations		
w.	Non-competition covenants		
x.	Dispute resolution		
y.	Other (describe)		

Exhibit C

Sample Item 17 Chart

ITEM 17

RENEWAL, TERMINATION, TRANSFER AND DISPUTE RESOLUTION

THE FRANCHISE RELATIONSHIP

This table lists certain important provisions of the franchise and related agreements. You should read these provisions in the agreements attached to this Disclosure Document.

Provision	Section in franchise or other agreement	Summary
(a) Length of the term of the franchise		
(b) Renewal or extension of the term		
(c) Requirements for you to renew or extend		
(d) Termination by you		
(e) Termination by us without cause		
(f) Termination by us with cause		
(g) "Cause" defined –defaults which can be cured		
(h) "Cause" defined – defaults which cannot be cured		
(i) Your obligations on termination/nonrenewal		
(j) Assignment of contract by us		
(k) "Transfer" by you-defined		
(l) Our approval of transfer by you		
(m) Conditions for our approval of transfer by you		
(n) Our right of first refusal to acquire your business		
(o) Our option to purchase your business		
(p) Your death or disability		
(q) Non-competition covenants during the term of the franchise		
(r) Non-competition covenants after the franchise is terminated or expires		
(s) Modification of the agreement		
(t) Integration/merger clause		
(u) Dispute resolution by arbitration or mediation		
(v) Choice of forum		
(w) Choice of law		

Exhibit D

Sample State Risk Factors

Please consider the following RISK FACTORS before you buy this franchise:

1. THE FRANCHISE AGREEMENT REQUIRES YOU TO RESOLVE DISPUTES WITH US BY MEDIATION, ARBITRATION OR LITIGATION ONLY IN [insert state]. OUT-OF-STATE MEDIATION, ARBITRATION OR LITIGATION MAY FORCE YOU TO ACCEPT A LESS FAVORABLE SETTLEMENT FOR DISPUTES. IT MAY ALSO COST MORE TO MEDIATE, ARBITRATE OR LITIGATE WITH US IN [insert state] THAN IN YOUR OWN STATE.
2. ALL OWNERS OF THE FRANCHISE AND THEIR SPOUSES WILL BE REQUIRED TO SIGN PERSONAL GUARANTIES. THIS REQUIREMENT PLACES THE PERSONAL AND MARITAL ASSETS OF THE FRANCHISE OWNER(S) AT RISK.
3. YOU MUST MAKE MINIMUM ROYALTY OR ADVERTISING PAYMENTS, REGARDLESS OF YOUR SALES LEVELS. YOUR INABILITY TO MAKE THE PAYMENTS MAY RESULT IN TERMINATION OF YOUR FRANCHISE AND LOSS OF YOUR INVESTMENT.
4. THE FRANCHISOR IS AT AN EARLY STAGE OF DEVELOPMENT AND HAS A LIMITED OPERATING HISTORY. THIS FRANCHISE COULD BE A HIGHER RISK INVESTMENT THAN A SYSTEM WITH A LONGER OPERATING HISTORY.
5. THE FRANCHISOR HAS LIMITED FINANCIAL RESOURCES WHICH MIGHT NOT BE ADEQUATE TO FUND THE FRANCHISOR'S PRE-OPENING OBLIGATIONS TO EACH FRANCHISEE AND PAY OPERATING EXPENSES.
6. THE FRANCHISOR WAS FORMED IN [month / year] HAS LITTLE OPERATING HISTORY OR RECORD OF PERFORMANCE. A FRANCHISEE'S ESTIMATED INITIAL INVESTMENT RANGING FROM [insert Item 7 range] EXCEEDS THE FRANCHISOR'S TOTAL STOCKHOLDER'S EQUITY OF [insert stockholder's equity from financial statements] at [insert ending date of financial statements].
7. THERE MAY BE OTHER RISKS CONCERNING THIS FRANCHISE.

Exhibit E

Sample State FDD Addenda

CALIFORNIA ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the California Franchise Investment Law, Cal. Corp. Code §§ 31000-31516 or the California Franchise Relations Act, Cal. Bus. & Prof. Code §§20000-20043 applies, the terms of this Addendum apply.

THE CALIFORNIA FRANCHISE INVESTMENT LAW REQUIRES THAT A COPY OF ALL PROPOSED AGREEMENTS RELATING TO THE SALE OF THE FRANCHISE BE DELIVERED TOGETHER WITH THE DISCLOSURE DOCUMENT.

OUR WEBSITE HAS NOT BEEN REVIEWED OR APPROVED BY THE CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT AND COMPLAINTS CONCERNING THE CONTENTS OF THIS WEBSITE MAY BE DIRECTED TO THE CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT AT .

SECTION 31125 OF THE CALIFORNIA CORPORATIONS CODE REQUIRES US TO GIVE YOU A DISCLOSURE DOCUMENT, IN A FORM CONTAINING THE INFORMATION THAT THE COMMISSIONER MAY BY RULE OR ORDER REQUIRE, BEFORE A SOLICITATION OF A PROPOSED MATERIAL MODIFICATION OF AN EXISTING FRANCHISE.

Item 3, Additional Disclosure:

Neither we nor any person described in Item 2 of the Disclosure Document is subject to any currently effective order of any National Securities Association or National Securities Exchange, as defined in the Securities Exchange Act of 1934, 15 U.S.C.A. 78a et seq. suspending or expelling such persons from membership in such association or exchange.

Item 6, Additional Disclosure:

The highest interest rate allowed by law in California is 10% annually.

Item 17, Additional Disclosures:

The franchise agreement requires franchisee to execute a general release of claims upon renewal or transfer of the franchise agreement. California Corporations Code Section 31512 provides that any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of that law or any rule or order there under is void. Section 31512 voids a waiver of your rights under the Franchise Investment Law (California Corporations Code Section 20010 voids a waiver of your rights under the Franchise Relations Act (Business and Professions Code Sections 20000 – 20043).

The franchise agreement requires application of the laws of _____. This provision may not be enforceable under California law.

The franchise agreement contains a liquidated damages clause. Under California Civil Code §1671, certain liquidated damages clauses are unenforceable.

California Business and Professions Code Sections 20000 through 20043 provide rights to the franchisee concerning termination, transfer or non-renewal of a franchise. If the franchise agreement contains a provision that is inconsistent with the law, the law will control.

The franchise agreement provides for termination upon bankruptcy. This provision may not be enforceable under federal bankruptcy law (11 U.S.C.A. §101 et seq.)

The franchise agreement requires binding arbitration. The arbitration will occur in _____ with the cost being borne by the parties as determined by the arbitrator. Prospective franchisees are encouraged to consult with private legal counsel to determine the applicability of California and federal laws (such as Business and Professions Code Section 20040.5, Code of Civil Procedure Section 1281, and the Federal Arbitration Act) to any provisions of a franchise agreement restricting venue to a forum outside the State of California.

The franchise agreement contains a covenant not to compete which extends beyond the termination of the franchise. This provision may not be enforceable under California law.

Item 19, Additional Disclosures:

The financial performance figures do not reflect the costs of sales, operating expenses, or other costs or expenses that must be deducted from the gross revenue or gross sales figures to obtain your net income or profit. You should conduct an independent investigation of the costs and expenses you will incur in operating your franchised business. Franchisees or former franchisees listed in the Disclosure Document may be one source of this information.

HAWAII ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Hawaii Franchise Investment Law, Hawaii Rev. Stat. §§482E-1 – 482E-12 applies, the terms of this Addendum apply.

THESE FRANCHISES WILL BE/HAVE BEEN FILED UNDER THE FRANCHISE INVESTMENT LAW OF THE STATE OF HAWAII. FILING DOES NOT CONSTITUTE APPROVAL, RECOMMENDATION OR ENDORSEMENT BY THE DIRECTOR OF COMMERCE AND CONSUMER AFFAIRS OR A FINDING BY THE DIRECTOR OF COMMERCE AND CONSUMER AFFAIRS THAT THE INFORMATION PROVIDED HEREIN IS TRUE, COMPLETE AND NOT MISLEADING.

THE FRANCHISE INVESTMENT LAW MAKES IT UNLAWFUL TO OFFER OR SELL ANY FRANCHISE IN THIS STATE WITHOUT FIRST PROVIDING TO THE PROSPECTIVE FRANCHISEE, AT LEAST SEVEN DAYS PRIOR TO THE EXECUTION BY THE PROSPECTIVE FRANCHISEE OF ANY BINDING FRANCHISE OR OTHER AGREEMENT, OR AT LEAST SEVEN DAYS PRIOR TO THE PAYMENT OF ANY CONSIDERATION BY THE FRANCHISEE, WHICHEVER OCCURS FIRST, A COPY OF THE FRANCHISE DISCLOSURE DOCUMENT, TOGETHER WITH A COPY OF ALL PROPOSED AGREEMENTS RELATING TO THE SALE OF THE FRANCHISE.

THIS FRANCHISE DISCLOSURE DOCUMENT CONTAINS A SUMMARY ONLY OF CERTAIN MATERIAL PROVISIONS OF THE FRANCHISE AGREEMENT. THE CONTRACT OR AGREEMENT SHOULD BE REFERRED TO FOR A STATEMENT OF ALL RIGHTS, CONDITIONS, RESTRICTIONS AND OBLIGATIONS OF BOTH THE FRANCHISOR AND FRANCHISEE.

ILLINOIS ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Illinois Franchise Disclosure Act, Ill. Comp. Stat. §§705/1 – 705/44 applies, the terms of this Addendum apply.

Item 17, Additional Disclosures. The following statements are added to Item 17:

The Illinois Franchise Disclosure Act governs the Franchise Agreement.

Section 4 of the Illinois Franchise Disclosure Act provides that any provision in a franchise agreement that designates jurisdiction or venue outside the State of Illinois is void. However, a franchise agreement may provide for arbitration outside of Illinois.

Section 41 of the Illinois Franchise Disclosure Act provides that any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with the Illinois Franchise Disclosure Act or any other law of Illinois is void.

Your rights upon termination and non-renewal of a franchise agreement are set forth in section 19 and 20 of the Illinois Franchise Disclosure Act.

MARYLAND ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Maryland Franchise Registration and Disclosure Law, Md. Code Bus. Reg. §§14-201 – 14-233 applies, the terms of this Addendum apply.

Item 17, Additional Disclosures:

Our termination of the Franchise Agreement because of your bankruptcy may not be enforceable under applicable federal law (11 U.S.C.A. 101 et seq.).

You may bring a lawsuit in Maryland for claims arising under the Maryland Franchise Registration and Disclosure Law.

Any claims arising under the Maryland Franchise Registration and Disclosure Law must be brought within 3 years after the grant of the franchise.

The general release required as a condition of renewal, sale and/or assignment/transfer will not apply to any liability under the Maryland Franchise Registration and Disclosure Law.

DISCLOSURES REQUIRED BY MICHIGAN LAW

[Per statute, the Michigan Addendum must immediately follow the cover sheet of the FDD and be in 12 point font.]

To the extent the Michigan Franchise Investment Law, Mich. Comp. Laws §§445.1501 – 445.1546 applies, the terms of this Addendum apply.

THE STATE OF MICHIGAN PROHIBITS CERTAIN UNFAIR PROVISIONS THAT ARE SOMETIMES IN FRANCHISE DOCUMENTS. IF ANY OF THE FOLLOWING PROVISIONS ARE IN THESE FRANCHISE DOCUMENTS, THE PROVISIONS ARE VOID AND CANNOT BE ENFORCED AGAINST YOU.

(a) A prohibition on the right of a franchisee to join an association of franchisees.

(b) A requirement that a franchisee assent to a release, assignment, novation, waiver, or estoppel which deprives a franchisee of rights and protections provided in this act. This shall not preclude a franchisee, after entering into a franchise agreement, from settling any and all claims.

(c) A provision that permits a franchisor to terminate a franchise prior to the expiration of its term except for good cause. Good cause shall include the failure of the franchisee to comply with any lawful provision of the franchise agreement and to cure such failure after being given written notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure such failure.

(d) A provision that permits a franchisor to refuse to renew a franchise without fairly compensating the franchisee by repurchase or other means for the fair market value at the time of expiration of the franchisee's inventory, supplies, equipment, fixtures, and furnishings. Personalized materials which have no value to the franchisor and inventory, supplies, equipment, fixtures, and furnishings not reasonably required in the conduct of the franchise business are not subject to compensation. This subsection applies only if: (i) the term of the franchise is less than 5 years, and (ii) the franchisee is prohibited by the franchise or other agreement from continuing to conduct substantially the same business under another trademark, service mark, trade name, logotype, advertising, or other commercial symbol in the same area subsequent to the expiration of the franchise or the franchisee does not receive at least 6 months advance notice of franchisor's intent not to renew the franchise.

(e) A provision that permits the franchisor to refuse to renew a franchise on terms generally available to other franchisees of the same class or type under similar circumstances. This section does not require a renewal provision.

(f) A provision requiring that arbitration or litigation be conducted outside this state. This shall not preclude the franchisee from entering into an agreement, at the time of arbitration, to conduct arbitration at a location outside this state.

(g) A provision which permits a franchisor to refuse to permit a transfer of ownership of a franchise, except for good cause. This subdivision does not prevent a franchisor from exercising a right of first refusal to purchase the franchise. Good cause shall include, but is not limited to:

(i) The failure of the proposed transferee to meet the franchisor's then-current reasonable qualifications or standards.

(ii) The fact that the proposed transferee is a competitor of the franchisor or subfranchisor.

(iii) The unwillingness of the proposed transferee to agree in writing to comply with all lawful obligations.

(iv) The failure of the franchisee or proposed transferee to pay any sums owing to the franchisor or to cure any default in the franchise agreement existing at the time of the proposed transfer.

(h) A provision that requires the franchisee to resell to the franchisor items that are not uniquely identified with the franchisor. This subdivision does not prohibit a provision that grants to a franchisor a right of first refusal to purchase the assets of a franchise on the same terms and conditions as a bona fide third party willing and able to purchase those assets, nor does this subdivision prohibit a provision that grants the franchisor the right to acquire the assets of a franchise for the market or appraised value of such assets if the franchisee has breached the lawful provisions of the franchise agreement and has failed to cure the breach in the manner provided in subdivision (c).

(i) A provision which permits the franchisor to directly or indirectly convey, assign, or otherwise transfer its obligations to fulfill contractual obligations to the franchisee unless provision has been made for providing the required contractual services.

THE FACT THAT THERE IS A NOTICE OF THIS OFFERING ON FILE WITH THE ATTORNEY GENERAL DOES NOT CONSTITUTE APPROVAL, RECOMMENDATION, OR ENDORSEMENT BY THE ATTORNEY GENERAL.

If the franchisee has any questions regarding this notice, those questions should be directed to the Michigan Department of Attorney General, Consumer Protection Division, Attn.: Franchise, 670 Law Building, Lansing, Michigan 48913, telephone: (517) 373-7117.

MINNESOTA ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Minnesota Franchise Act, Minn. Stat. §§80C.01 – 80C.22 applies, the terms of this Addendum apply.

State Cover Page and Item 17, Additional Disclosures:

Minn. Stat. Sec. 80C.21 and Minn. Rule 2860.4400J prohibit us from requiring litigation to be conducted outside of Minnesota, requiring waiver of a jury trial or requiring the franchisee to consent to liquidated damages, termination penalties or judgment notes. In addition, nothing in the Disclosure Document shall abrogate or reduce any of your rights as provided for in Minn. Stat. Sec. 80C, or your rights to any procedure, forum or remedies provided for by the laws of the jurisdiction.

Franchisee cannot consent to the franchisor obtaining injunctive relief. The franchisor may seek injunctive relief. A court will determine if a bond is required.

Item 6, Additional Disclosure:

NSF checks are governed by Minn. Stat. 604.113, which puts a cap of \$30 on service charges.

Item 13, Additional Disclosures:

The Minnesota Department of Commerce requires that a franchisor indemnify Minnesota Franchisees against liability to third parties resulting from claims by third parties that the franchisee's use of the franchisor's trademark infringes upon the trademark rights of the third party. The franchisor does not indemnify against the consequences of a franchisee's use of a franchisor's trademark except in accordance with the requirements of the franchise agreement, and as the condition to an indemnification, the franchisee must provide notice to the franchisor of any such claim immediately and tender the defense of the claim to the franchisor. If the franchisor accepts tender of defense, the franchisor has the right to manage the defense of the claim, including the right to compromise, settle or otherwise resolve the claim, or to determine whether to appeal a final determination of the claim.

Item 17, Additional Disclosures:

Any condition, stipulation or provision, including any choice of law provision, purporting to bind any person who, at the time of acquiring a franchise is a resident of the State of Minnesota or in the case of a partnership or corporation, organized or incorporated under the laws of the State of Minnesota, or purporting to bind a person acquiring any franchise to be operated in the State of Minnesota to waive compliance or which has the effect of waiving compliance with any provision of the Minnesota Franchise Law is void.

We will comply with Minn. Stat. Sec. 80C.14, subds. 3, 4 and 5, which requires, except in certain specified cases, that a franchisee be given 90 days notice of termination (with 60 days to cure), 180 days notice for nonrenewal of the Franchise Agreement, and that consent to the transfer of the franchise will not be unreasonably withheld.

Minnesota Rule 2860.4400D prohibits a franchisor from requiring a franchisee to assent to a general release, assignment, novation, or waiver that would relieve any person from liability imposed by Minnesota Statute §§80C.01 – 80C.22.

The limitations of claims section must comply with Minn. Stat. Sec. 80C.17, subd. 5.

NEW YORK ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the New York General Business Law, Article 33, §§680 - 695 applies, the terms of this Addendum apply.

Cover Page, Additional Disclosure.

INFORMATION COMPARING FRANCHISORS IS AVAILABLE. CALL THE STATE ADMINISTRATORS LISTED IN EXHIBIT _____ OR YOUR PUBLIC LIBRARY FOR SOURCES OF INFORMATION. REGISTRATION OF THIS FRANCHISE BY NEW YORK STATE DOES NOT MEAN THAT NEW YORK STATE RECOMMENDS IT OR HAS VERIFIED THE INFORMATION IN THIS FRANCHISE DISCLOSURE DOCUMENT. IF YOU LEARN THAT ANYTHING IN THE FRANCHISE DISCLOSURE DOCUMENT IS UNTRUE, CONTACT THE FEDERAL TRADE COMMISSION AND NEW YORK STATE DEPARTMENT OF LAW, BUREAU OF INVESTOR PROTECTION AND SECURITIES, 120 BROADWAY, 23RD FLOOR, NEW YORK, NEW YORK 10271. THE FRANCHISOR MAY, IF IT CHOOSES, NEGOTIATE WITH YOU ABOUT ITEMS COVERED IN THE FRANCHISE DISCLOSURE DOCUMENT. HOWEVER, THE FRANCHISOR CANNOT USE THE NEGOTIATING PROCESS TO PREVAIL UPON A PROSPECTIVE FRANCHISEE TO ACCEPT TERMS WHICH ARE LESS FAVORABLE THAN THOSE SET FORTH IN THIS FRANCHISE DISCLOSURE DOCUMENT.

Item 3, Additional Disclosure. The last sentence in Item 3 is deleted and replaced with the following:

Neither we, nor any of our predecessors, nor any person identified in Item 2 above, nor any affiliate offering franchises under our trademark, has any administrative, criminal, or a material civil or arbitration action pending against him alleging a violation of any franchise law, fraud, embezzlement, fraudulent conversion, restraint of trade, unfair or deceptive practices, misappropriation of property, or comparable allegations.

Neither we, nor any of our predecessors, nor any person identified in Item 2 above, nor any affiliate offering franchises under our trademark, has been convicted of a felony or pleaded nolo contendere to any other felony charge or, during the ten-year period immediately preceding the application for registration, been convicted of a misdemeanor or pleaded nolo contendere to any misdemeanor charge or been found liable in an arbitration proceeding or a civil action by final judgment, or been the subject of any other material complaint or legal or arbitration proceeding if such misdemeanor conviction or charge, civil action, complaint, or other such proceeding involved a violation of any franchise law, securities law, fraud, embezzlement, fraudulent conversion, restraint of trade, unfair or deceptive practices, misappropriation of property, or comparable allegation.

Neither we, nor any of our predecessors, nor any person identified in Item 2 above, nor any affiliate offering franchises under our trademark, is subject to any currently effective injunctive or restrictive order or decree relating to franchises, or under any federal, state, or Canadian franchise, securities, antitrust, trade

regulation, or trade practice law as a result of a concluded or pending action or proceeding brought by a public agency; or is subject to any currently effective order of any national securities association or national securities exchange, as defined in the Securities and Exchange Act of 1934, suspending or expelling such person from membership in such association or exchange; or is subject to a currently effective injunctive or restrictive order relating to any other business activity as a result of an action brought by a public agency or department, including, without limitation, actions affecting a license as a real estate broker or sales agent.

Item 4, Additional Disclosure. Item 4 is deleted and replaced with the following:

Neither we nor any of our predecessors, affiliates, or officers, during the 10-year period immediately before the date of the Disclosure Document: (a) filed as debtor (or had filed against it) a petition to start an action under the U.S. Bankruptcy Code; (b) obtained a discharge of its debts under the Bankruptcy Code; or (c) was a principal officer of a company or a general partner in a partnership that either filed as a debtor (or had filed against it) a petition to start an action under the U.S. Bankruptcy Code or that obtained a discharge of its debts under the U.S. Bankruptcy Code during or within one year after the officer or general partner of the franchisor held this position in the company or partnership.

Item 5, Additional Disclosures.

The initial franchise fee constitutes part of our general operating funds and will be used as such in our discretion.

Item 17, Additional Disclosures.

The following is added to the Summary sections of Item 17(c) and 17(m): To the extent required by applicable law, all rights you enjoy and any causes of action arising in your favor from the provisions of Article 33 of the General Business Law of the State of New York and the regulations issued thereunder shall remain in force; it being the intent of this proviso that the non-waiver provisions of General Business Law Section 687.4 and 687.5 be satisfied.

The Summary section of Item 17(d) is deleted and replaced with the following language: You may terminate the agreement on any grounds available by law.

The following is added to the Summary section of Item 17(j): No assignment will be made except to an assignee who in good faith and judgment of the franchisor is willing and financially able to assume the franchisor's obligations under the Franchise Agreement.

The following is added to the Summary sections of Items 17(v) and 17(w): The foregoing choice of law should not be considered a waiver of any right conferred upon the franchisor or upon the franchisee by Article 33 of the General Business Law of the State of New York.

NORTH DAKOTA ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the North Dakota Franchise Investment Law, N.D. Cent. Code, §§51-19-01 – 51-19-17 applies, the terms of this Addendum apply.

Item 17, Additional Disclosures. The following statements are added to Item 17:

Any provision requiring franchisees to consent to the jurisdiction of courts outside North Dakota or to consent to the application of laws of a state other than North Dakota may be unenforceable under North Dakota law. Any mediation or arbitration will be held at a site agreeable to all parties. If the laws of a state other than North Dakota govern, to the extent that such law conflicts with North Dakota law, North Dakota law will control.

Any general release the franchisee is required to assent to as a condition of renewal is not intended to nor shall it act as a release, estoppel or waiver of any liability franchisor may have incurred under the North Dakota Franchise Investment Law.

Covenants not to compete during the term of and upon termination or expiration of the franchise agreement are enforceable only under certain conditions according to North Dakota law. If the Franchise Agreement contains a covenant not to compete that is inconsistent with North Dakota law, the covenant may be unenforceable.

The Franchise Agreement includes a waiver of exemplary and punitive damages. This waiver may not be enforceable under North Dakota law.

The Franchise Agreement stipulates that the franchisee shall pay all costs and expenses incurred by franchisor in enforcing the agreement. For North Dakota franchisees, the prevailing party is entitled to recover all costs and expenses, including attorneys' fees.

The Franchise Agreement requires the franchisee to consent to a waiver of trial by jury. This waiver may not be enforceable under North Dakota law.

The Franchise Disclosure Document and Franchise Agreement state that franchisee must consent to the jurisdiction of courts outside that State of North Dakota. That requirement may not be enforceable under North Dakota law.

The Franchise Disclosure Document and Franchise Agreement may require franchisees to consent to termination or liquidated damages. This requirement may not be enforceable under North Dakota law.

The Franchise Agreement requires the franchisee to consent to a limitation of claims within one year. To the extent this requirement conflicts with North Dakota law, North Dakota law will apply.

RHODE ISLAND ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Rhode Island Franchise Investment Act, R.I. Gen. Law ch. 395 §§19-28.1-1 – 19-28.1-34 applies, the terms of this Addendum apply.

Item 17, Additional Disclosure. The following statement is added to Item 17:

Section 19-28.1-14 of the Rhode Island Franchise Investment Act provides that:
“A provision in a franchise agreement restricting jurisdiction or venue to a forum outside this state or requiring the application of the laws of another state is void with respect to a claim otherwise enforceable under this Act.”

VIRGINIA ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Virginia Retail Franchising Act, Va. Code §§13.1-557 – 13.1-574 applies, the terms of this Addendum apply.

Item 17, Additional Disclosures:

Any provision in any of the contracts that you sign with us which provides for termination of the franchise upon the bankruptcy of the franchisee may not be enforceable under federal bankruptcy law (11 U.S.C. 101 et. seq.).

“According to Section 13.1 – 564 of the Virginia Retail Franchising Act, it is unlawful for a franchisor to cancel a franchise without reasonable cause. If any grounds for default or termination stated in the franchise agreement does not constitute “reasonable cause,” as that term may be defined in the Virginia Retail Franchising Act or the laws of Virginia, that provision may not be enforceable.”

WASHINGTON ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Washington Franchise Investment Protection Act, Wash. Rev. Code §§19.100.010 – 19.100.940 applies, the terms of this Addendum apply.

Item 17, Additional Disclosure:

The state of Washington has a statute, RCW 19.100.180 which may supersede the Franchise Agreement in your relationship with the franchisor including the areas of termination and renewal of your franchise. There may also be court decisions which may supersede the Franchise Agreement in your relationship with the franchisor including the areas of termination and renewal of your franchise.

In any arbitration involving a franchise purchased in Washington, the arbitration site shall be either in the state of Washington, or in a place mutually agreed upon at the time of the arbitration, or as determined by the arbitrator.

In the event of a conflict of laws, the provisions of the Washington Franchise Investment Protection Act, Chapter 19.100 RCW shall prevail.

A release or waiver of rights executed by a franchisee shall not include rights under the Washington Franchise Investment Protection Act except when executed pursuant to a negotiated settlement after the agreement is in effect and where the parties are represented by independent counsel.

Provisions such as those which unreasonably restrict or limit the statute of limitations period for claims under the Act, rights or remedies under the Act such as a right to a jury trial may not be enforceable.

Transfer fees are collectable to the extent that they reflect the franchisor's reasonable estimated or actual costs in effecting a transfer.

WISCONSIN ADDENDUM TO FRANCHISE DISCLOSURE DOCUMENT

To the extent the Wisconsin Franchise Investment Law, Wis. Stat. §§553.01 – 553.78 or Wisconsin Fair Dealership Law, Wis. Stat. §§135.01 – 135.07 applies, the terms of this Addendum apply.

Item 17, Additional Disclosures:

For all franchisees residing in the State of Wisconsin, we will provide you at least 90 days' prior written notice of termination, cancellation or substantial change in competitive circumstances. The notice will state all the reasons for termination, cancellation or substantial change in competitive circumstances and will provide that you have 60 days in which to cure any claimed deficiency. If this deficiency is cured within 60 days, the notice will be void. If the reason for termination, cancellation or substantial change in competitive circumstances is nonpayment of sums due under the franchise, you will have 10 days to cure the deficiency.

For Wisconsin franchisees, Ch. 135, Stats., the Wisconsin Fair Dealership Law, supersedes any provisions of the Franchise Agreement or a related contract which is inconsistent with the Law.

Exhibit F

Initial State Registration Requirements

State	Initial Franchise Application Filing Requirements	Filing Fee	Electronic Filing
California	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Customer Authorization of Disclosure of Financial Records, California Internet Advertising Exemption Notice, Franchise Seller Disclosure Forms, and 1 copy of the FDD.	\$675	Permitted
Hawaii	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 2 copies of the FDD.	\$250	N/A
Illinois	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, 1 paper copy of the FDD and 1 copy of the FDD on CD-ROM (in PDF format).	\$500	N/A
Indiana	Uniform Franchise Registration Application, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms on CD-ROM (if more than 1 or 2), and 1 copy of the FDD on CD-ROM.	\$500	N/A
Maryland	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 1 copy of the FDD (all documents must be in paper and on a CD-ROM).	\$500	N/A
Minnesota	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 1 paper copy of the FDD and 1 copy of the FDD on CD-ROM (in PDF format).	\$400	Permitted
New York	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Uniform Franchise Consent to Service of Process, Consent of Accountant, Franchise Seller Disclosure Forms, 1 copy of the Franchisor's financial statements, and 2 copies of the FDD.	\$750	N/A
North Dakota	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 1 copy of the FDD on CD-ROM.	\$250	N/A
Rhode Island	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 1 copy of the FDD.	\$600	Online or CD-ROM only
South Dakota	Franchise Notice Filing Application, Uniform Franchise Consent to Service of Process, and 1 copy of the FDD on CD-ROM.	\$250	N/A
Virginia	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, and 1 copy of the FDD (all documents must be in paper and on CD-ROM).	\$500	N/A
Washington	Uniform Franchise Registration Application, Franchisor's Costs and Sources of Funds, Consent of Accountant, Uniform Franchise Consent to Service of Process, Franchise Seller Disclosure Forms, and 2 copies of the FDD.	\$600	Permitted
Wisconsin	Uniform Franchise Registration Application, Uniform Franchise Consent to Service of Process, and 1 copy of the FDD.	\$400	Required

Exhibit G

Federal & State Franchise Exemptions

Franchise Exemptions Overview

The following tables were created as a quick reference guide only. Please remember the burden of proving eligibility for any exemption or exception is on the entity claiming it. It is strongly recommended that you read and then re-read the specific language of each statute before relying on an exemption or exception.

State	Large Franchisor	Large Franchisee	Large Investment	Insider	Institutional Franchisee	Fractional Franchise	Single Franchise
FTC		X	X	X		X	
California	X	X		X		X	
Hawaii					X		
Illinois	X	X	X	X	X	X	X
Indiana	X					X	X
Maryland	X		X		X		
Michigan					X	X	
Minnesota			X		X	X	X
New York	X				X	X	X
North Dakota	X						
Rhode Island	X	X		X			
South Dakota		X	X	X	X	X	
Virginia	X		X		X	X	
Washington	X	X		X	X		X
Wisconsin			X		X	X	

State	Out of State	Nominal Fee	Sale by Judicial Officer	Renewal, Extension, Amendment or Modification of Agreement ¹⁸⁷	Sale by Existing Franchisee ¹⁸⁸	Sale to Existing Franchisee ²	By Order	Leased Departments	Securities
FTC		X		X	X	X		X	
California	X	X		X	X	X			
Hawaii	X		X	X	X	X	X		
Illinois	X	X		X	X		X	X	
Indiana				X	X		X		
Maryland	X	X		X	X	X	X		
Michigan	X	X	X	X	X	X			
Minnesota	X	X	X		X		X	X	X
New York ¹⁸⁹				X	X	X	X		
North Dakota				X	X		X		
Rhode Island	X		X	X	X	X	X	X	
South Dakota	X	X	X	X	X	X	X	X	
Virginia	X			X	X	X		X	
Washington		X	X		X	X			X
Wisconsin	X	X		X	X	X	X		X

¹⁸⁷ This assumes no material changes to the terms and conditions of the franchise agreement are required.

¹⁸⁸ Franchisor must not play a significant role in the sale (permissible for franchisor to approve transfer).

¹⁸⁹ New York also provides for a trade show exemption, which allows a franchisor to show at the trade show for three days. No offers of sales.

Exhibit H

Advertising Registration Requirements

Summary of State Advertising Requirements

State	File # Days Prior to Use	# Copies To Be Filed	Special Requirements—General	Special Requirements—Financial Performance Representations	Internet Exemption
CA	3 bus.	1 <i>(but unpublished requirement of 2 copies for review purposes)</i>	Advertisement must: (1) include name and address of franchisor; (2) if referring to registration of a franchise, must include disclaimer of state endorsement in capital letters of no less than 10-point type: "THESE FRANCHISES HAVE BEEN REGISTERED UNDER THE FRANCHISE INVESTMENT LAW OF THE STATE OF CALIFORNIA. SUCH REGISTRATION DOES NOT CONSTITUTE APPROVAL, RECOMMENDATION OR ENDORSEMENT BY THE COMMISSIONER OF CORPORATIONS NOR A FINDING BY THE COMMISSIONER THAT THE INFORMATION PROVIDED HEREIN IS TRUE, COMPLETE AND NOT MISLEADING."; (3) if including an endorsement of a public figure, disclose any compensation or benefit to that individual; and (4) if containing a claim of an exemption from or reduction in tax liability, such claim must be based on the opinion of counsel, which counsel must be named in the advertisement.	Advertisement should not contain any statement or inference that purchase of franchise is a safe investment or that failure, loss or default is impossible or unlikely, or that earnings or profits are assured and any actual earnings claims made must conform with Item 19 of the disclosure document. ¹⁹⁰	Internet offer exempt if: (1) franchisor files with the Commissioner a written notice, executed by franchisor's officer or general partner that includes (a) URL address, (b) statement that the franchisor agrees to comply with CFIL when posting any internet advertisement, and (c) franchisor's name, address, telephone number, and contact person; (2) advertisement is not directed to any state resident; and (3) preface, exhibit or appendix of the franchisor's disclosure document includes URL address and the following statement of not less than 12-point type: "OUR WEBSITE HAS NOT BEEN REVIEWED OR APPROVED BY THE CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT, ANY COMPLAINTS CONCERNING THE CONTENT OF THIS WEBSITE MAY BE DIRECTED TO THE CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT at ." Cal. Code Regs. tit. 10, § 310.156.3. (Cal., ¶ 5050.355.)

¹⁹⁰ While "earnings claims" are now referred to as "financial performance representations," some states still have not changed their statutes to reflect the change.

State	File # Days Prior to Use	# Copies To Be Filed	Special Requirements—General	Special Requirements—Financial Performance Representations	Internet Exemption
MD	<p>5 days Md., (CCH) ¶ 5200.09.</p> <p><i>but</i></p> <p>7 bus. Md., (CCH) ¶ 3200.25.</p>	1	Advertisement must: (1) include name and address of franchisor in promotional materials; (2) submit written transcript for video/audio promotional materials and description of the contents; and (3) include name and address of counsel if opinion of counsel is provided in advertisement.	Advertisement for franchise offering may not refer to: (1) the purchase or sale of franchise as safe investment, as free from risk of loss or default, or as guarantee or assurance of earnings or profits; and (2) an earnings claim, unless otherwise permitted by Commissioner.	<p>Internet offer exempt from statutory filing requirements if (1) the advertisement states that the offer is not directed to residents of the state, (2) the advertisement is not actually directed to any resident of the state, and (3) no franchises are sold in the state until the franchisor obtains state registration.</p> <p>Md., ¶ 5200.18.</p>
MN	<p>5 bus.</p> <p><i>(may publish advertisement if examiner does not issue a comment letter within 3 bus. days after filing.)</i></p>	1	Advertisement must include: (1) name and address of franchisor, including primary commercial symbol of the franchisor; (2) state registration number assigned to the offering; and (3) name and address of counsel if opinion of counsel is provided in advertisement.	No advertisement shall make reference to: (1) acquiring of franchise as an assurance of earnings or profits, as safe investment, or as free from loss, default, or failure or that such is impossible or unlikely; and (2) projections or statements of operations or income from operation of any franchise.	<p>Internet offer exempt from statutory filing requirements if (1) the advertisement states that the offer is not directed to residents of the state, (2) the advertisement is not actually directed to any resident of the state, and (3) no franchises are sold in the state until the franchisor obtains state registration.</p> <p>Minn., ¶ 5230.81-.82</p>

State	File # Days Prior to Use	# Copies To Be Filed	Special Requirements—General	Special Requirements—Financial Performance Representations	Internet Exemption
NY	7	1 (2 copies must be submitted with the prospectus or disclosure document). N.Y., ¶ 5320.03.	<p>Advertisement must: (1) be verified in writing that the advertisement is not inconsistent with filed prospectus; (2) cover letter must state: “we verify that the enclosed advertisement is consistent with the filed Franchise Disclosure Document” (in addition to separate verification); and, (3) sales literature must state in easily readable print:</p> <p>“This advertisement is not an offering. An offering can only be made by a prospectus filed first with the Department of Law of the State of New York. Such filing does not constitute approval by the Department of Law.”</p> <p>Or, the following.¹⁹¹</p> <p>“This offering is made by prospectus only.”</p> <p>(4) Any radio or television advertisement must include a statement that no offer of a franchise is made except by prospectus.</p>	No sales literature shall include any representation or statement inconsistent with prospectus on file with Department.	<p>Internet offer exempt if: (1) franchisor’s URL address is stated (a) on the cover page of a franchise disclosure document included with an application for state registration, (b) on the cover page of a franchise disclosure document included with an application for exemption from registration that is on file with the New York State Department of Law, or (c) on a notice filed with the New York State Department of Law, (2) the internet advertising is not directed at any person in the state, (3) the advertisement states that the offer is not directed to residents of the state, (4) the advertisement is not actually directed to any resident of the state, and (5) no franchises are sold in the state until the franchisor obtains state registration.</p> <p>N.Y., ¶ 5320.12-.13.</p>
ND	5 bus.	1	None.	None.	<p>Internet offer exempt from statutory filing requirements if (1) the advertisement states that the offer is not directed to residents of the state, (2) the advertisement is not actually directed to any resident of the state, and (3) no franchises are sold in the state until the franchisor obtains state registration.</p> <p>N.D., ¶ 5340.02.</p>

¹⁹¹ This second notice is to be used with print advertisements no more than 5” long/1 column wide and broadcast advertisements of 30 seconds or less.

State	File # Days Prior to Use	# Copies To Be Filed	Special Requirements—General	Special Requirements—Financial Performance Representations	Internet Exemption
WA	7	1	Advertisement must: (1) include name and address of franchisor in promotional materials, (2) if relying on endorsement of public figure, disclose any compensation or benefit to that individual; and (3) if advertisement contains a claim of an exemption from or reduction in tax liability, such claim must be based on the opinion of counsel, which counsel must be named in the advertisement.	Advertisement should: (1) not contain any statement or inference that purchase of franchise is safe investment or that failure, loss or default is impossible or unlikely, or that earnings or profits are assured; and (2) not normally contain projection of future franchisee earnings unless projection is (a) based on past earnings records of all franchisees operating under conditions, including location, substantially similar to conditions affecting franchises being offered (b) for a reasonable period only and (c) is substantiated by data which clearly supports projections	<p>Internet offer not subject to registration requirement if (1) the offer is made pursuant to an exemption from registration; or (2) if the franchise is not registered, (a) the offer indicates that the franchises are not being offered to residents in the state, (b) the internet offer is not otherwise directed to any person in the state, (c) no franchises are sold in the state until the offering is registered.</p> <p>Wash., ¶ 5470.25.</p> <p>Internet offer that is required to be registered in the state is exempt from statutory filing requirements if (1) franchisor's URL address is stated (a) on the cover page of the franchise disclosure document included with an application for state registration, or (b) on a notice filed with the director within five business days after publication; and (2) the internet advertising is not directed at any person in the state.</p> <p>Wash., ¶ 5470.24.</p>