United States

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Introduction

The United States of America (U.S.) was the first country to adopt a franchise law when California in 1970 adopted the California Franchise Investment Law, effective January 1, 1971. Subsequently, between 1971 and 1980, a number of other states and the Federal Trade Commission (FTC) adopted various forms of franchise sales laws or regulations. All of those laws and regulations required pre-sale disclosure, and initially all but the federal regulation and one state law required registration. Although many of those laws and regulations have since been amended or revised, no new franchise sales law or regulation has been enacted in the U.S. since New York's law was enacted in 1980, and many have since simplified their registration process.

Because the original federal disclosure regulation did not fully preempt the state laws, the states were essentially free to enforce their own sales laws. A state organization called the Midwest Securities Commissioners Association (now known as the North American Securities Administrators Association, or NASAA) adopted a disclosure format in 1974 known as the Uniform Franchise Offering Circular (UFOC) Guidelines, which the FTC allowed the states to use instead of the FTC's own disclosure requirements. The UFOC Guidelines were amended several times. Most franchisors in the United States used the UFOC Guidelines' disclosure format for a variety of reasons.

The most significant revision in U.S. franchise sales law occurred July 1, 2007, when the FTC adopted an amended version of its federal disclosure regulation (FTC Franchise Rule). The FTC Franchise Rule disclosure format was essentially a modified version of the UFOC Guidelines and required all franchisors to convert to a modified format called a Franchise Disclosure Document (FDD) by July 1, 2008. Subsequently, a number of the states with franchise sales laws have modified their laws to conform more closely to the revised FTC requirements, and NASAA adopted its 2008 Franchise Registration and Disclosure Guidelines to provide a procedure for states to enforce their own franchise sales laws in conjunction with the federal requirements.

While the history of franchise sales regulation in the United States would make for interesting reading (to some of us, at least), this chapter instead focuses on the current U.S. franchise sales requirements in the U.S. as reflected in the FTC Franchise Rule, the 15 state franchise sales laws, the NASAA 2008 Franchise Registration and Disclosure Guidelines, and other explanatory materials or guidance issued by the FTC, NASAA, and the states, and is current through January 2015.

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I. What Is a Franchise?

A. Scope of Law

The United States of America (U.S.) legal system is a federal system, and both the federal government and a number of the states have enacted franchise sales laws or promulgated franchise sales regulations. Since 1970, when California enacted the first law, 15 states and the Federal Trade Commission (FTC) have adopted franchise disclosure, registration, or notice laws or regulations that apply to the sale of a franchise. All of those regulations and laws define "franchise." Unfortunately, the U.S. does not have a uniform definition, and the definition in each applicable law or regulation must be reviewed by a franchise seller to determine its applicability to a particular system.

Franchisors should also understand that a variety of other federal and state laws can affect the franchise relationship: business opportunity laws, relationship laws, and special industry laws. This chapter focuses on franchise sales laws and regulations, but Section VIII discusses the relationship laws. The special industry laws that relate to sellers in specific industries (e.g., automobile dealers, petroleum marketing, farm and industrial equipment, etc.) are not covered.

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The FTC promulgated its original Trade Regulation Rule on Franchising and Business Opportunity Ventures in 1978 (Original FTC Franchise Rule). The Original FTC Franchise Rule required disclosure but no registration or filing with the FTC. Although the Original FTC Franchise Rule applied in all 50 states and U.S. territories and possessions, it preempted state franchise sales law only in a limited respect. That left the 15 states that adopted their own disclosure, registration, or notice laws free to enforce them in most respects.

On July 1, 2007, an amended version of the FTC Franchise Rule, called Disclosure Requirements and Prohibitions Concerning Franchising (FTC Franchise Rule), became effective. The FTC Franchise Rule defines "franchise" as follows:

> *Franchise* means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:
> (1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;
> (2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and
> (3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.

The FTC Franchise Rule will not apply if the total required payments, or commitments to make a required payment, to the Franchisor or an affiliate that are made at any time from before to within six months after commencing operation of the Franchisee's business are less than $500. A "required payment" is defined in the FTC Franchise Rule as "all consideration that the Franchisee must pay to the Franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise. A required payment does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease." Because of the bona fide wholesale price exception, the typical distribution system that requires no payments other than the purchase price of goods is not a franchise.

All three elements of the franchise definition must be present in order for a franchise to exist. If any one element is missing, there is no franchise for purposes of the FTC Franchise Rule.

Under the FTC Franchise Rule, in connection with the offer or sale of a franchise to be located in the U.S. or its territories, a Franchisor must provide a prospective Franchisee with a copy of its current disclosure document at least 14 calendar days before the prospective Franchisee signs a binding agreement with or makes any payment to the Franchisor or an affiliate in connection with the proposed franchise sale. The disclosure document, called a Franchise Disclosure Document (FDD), must contain information in 23 different categories. No filing or registration with the FTC is required.

All Franchisors in the U.S. had to convert to the FDD format by July 1, 2008. However, the FTC expressly provided that it did not intend to preempt the franchise laws of any state or local government except to the extent of any inconsistency with the FTC Franchise Rule. A law is not inconsistent with FTC Franchise Rule if it provides prospective Franchisees with equal or greater protection, such as registration of disclosure documents or more extensive disclosures.

Fifteen states have non-preempted registration, disclosure, or notice filing franchise sales laws (with the approximate original effective date year): California (1971), Hawaii (1975), Illinois (1974), Indiana (1975), Maryland (1978), Michigan (1974), Minnesota (1973), New York (1980), North Dakota (1975), Oregon (1973), Rhode Island (1973), South Dakota (1974), Virginia (1972), Washington (1972), and Wisconsin (1972). All of these states require that a Disclosure Document (now only in the FDD format) be provided to a prospective Franchisee prior to the franchise sale, and all except Oregon require some registration or filing with the state prior to selling or offering to sell a franchise.

The state law definitions of "franchise" vary somewhat. The California Franchise Investment Law definition was the model for the definitions used in most of the other states with franchise sales laws. Under the California definition:

> "Franchise" means a contract or agreement, either express or implied, whether oral or written, between two or more persons by which:

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(1) A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and
(2) The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate; and
(3) The franchisee is required to pay, directly or indirectly, a franchise fee.

Under the California Franchises Regulations, registration and disclosure requirements exempt any offer or sale of a franchise that would be subject to registration solely because the Franchisee is required to pay, directly or indirectly, a franchise fee that does not exceed $500 annually. California defines "franchise fee" as "any fee or charge that a franchisee or Sub-franchisor is required to pay or agrees to pay for the right to enter into a business under a franchise agreement, including, but not limited to, any payment for goods and services."

Many of the states that used the California statute as a model modified the definition of "franchisor" somewhat. In Illinois, Rhode Island, Washington, and Wisconsin, the marketing plan can be prescribed or "suggested." Hawaii and Minnesota substitute the requirement that there be a community of interest in the marketing of the seller's goods or services for the marketing plan element. In 2008, South Dakota amended its Franchise Investment Law to adopt the FTC Franchise Rule, including its definition of "franchise."

Generally, to have a prescribed (or suggested) marketing plan or system, the Franchisor must direct or suggest to the Franchisee how to sell the goods or services to the public. In most cases, the Franchisor provides the Franchisee with an operating manual setting forth the details of the plan or system. But a prescribed (or suggested) marketing plan or system can be found in a business relationship, even in the absence of a manual, based on combinations of the following types of elements: prescribing of exclusive territories; requiring mandatory training; retaining or exercising approval over sales personnel; providing product information and sales strategies; promising support in marketing, training, advertising, and promotion; and prescribing sales quotas. Only a few of the state franchise sales laws define a "marketing plan" or "marketing plan or system."

With respect to trademark association, while most of these states require that the business be associated with the putative Franchisor's mark, some states will find trademark association sufficient to meet the franchise definition threshold where a manufacturer or distributor sells a trademarked product and provides sales materials that bear the mark.

A franchise fee generally is any fee or charge, including up-front payments or subsequent royalties, required purchases, advertising fees, or other fees that the Franchisee is required to pay directly or indirectly for the right to enter into the business. It includes hidden charges, such as equipment which the Franchisee may be required to purchase. However, in all of the franchise sales states, the purchase of goods (not services) at a bona fide wholesale price in a quantity that a reasonable businessman normally would purchase by way of a starting and ongoing inventory is exempted from the franchise fee definition. It is the absence of a fee requirement in the business relationship that exempts most companies that sell through distributorships from being covered by these laws. A payment made to an unrelated third party, even if required, would not be a franchise fee. Generally, the payment of ordinary business expenses would not be the payment of a franchise fee.

The New York Franchises Act is unique because it has alternative definitions of a franchise, each with only two elements. New York defines "franchise" as a contract in which either:

(a) a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor, and the franchisee is required to pay, directly or indirectly, a franchise fee, or
(b) a franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate, and the franchisee is required to pay, directly or indirectly, a franchise fee.

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As in the other states with franchise sales laws and the FTC Franchise Rule, New York's definition of "franchise fee" provides that the purchase or agreement to purchase goods at a bona fide wholesale price is not the payment of a franchise fee.

In all of the states, all of the elements of the statutory definition must be present in order to have a franchise. If any one element is missing, there will not be a franchise according to that state law.

All of the 15 franchise sales states require that the prospective Franchisee receive an FDD prior to sale, but the timing of the pre-sale disclosure varies somewhat, as discussed in Section IV. Because the FTC did not fully preempt the state franchise sales laws, the states with franchise sales laws remain free to require additional disclosure obligations, and many do. The FTC Franchise Rule provides that Franchisors can provide multistate disclosure documents by including non-preempted, state-specific information in the text of the FDD or in attached exhibits. Many Franchisors add state-specific addenda to their FDDs to provide the additional disclosures required by some of the states. In addition, the North American Securities Administrators Association (NASAA) 2008 Franchise Registration and Disclosure Guidelines (2008 Guidelines) require a separate state cover page to address certain items not addressed by the FTC Franchise Rule's cover page.

It is interesting to note that all 15 state franchise sale laws were adopted within a relatively short time frame (from 1971 to 1980, but most from 1971 to 1975), and that no new state franchise sales laws have been adopted in the U.S. since 1980, although most of those laws have been amended, revised, or replaced since then.

In conclusion, the definition of "franchise" in the FTC Franchise Rule is different from all the states (except South Dakota), although the FTC definition essentially has three similar definitional elements, and the FTC has claimed that its definition was "entirely consistent with the principles underlying the various state definitions." Nevertheless, it is possible that a program may be covered by the FTC Franchise Rule and not by one of the state franchise sales laws, or vice versa. It is also possible that a particular program may be regulated by some of the state franchise sales laws but not others.

Finally, seven of the registration states require the Franchisor to file advertisements for the sale of franchises with state authorities prior to use.

B. Applicability to Master Franchising

All of the U.S. franchise sales laws and regulations apply to a Master Franchise relationship but are referred to in those laws or regulations as "sub-franchises."

The definition of "franchisor" in the FTC Franchise Rule states that "franchisor includes sub-franchisors." For purposes of the "franchise" definition, a Sub-franchisor is defined as "a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance." The FTC Compliance Guide explains that the term does not include a third-party broker with no post-sale performance obligations, even if called a Sub-franchisor.

The FTC Franchise Rule then provides that "sub-franchisors shall disclose the required information about the franchisor, and, to the extent applicable, the same information concerning the sub-franchisor."

The state franchise sales laws vary in how they address sub-franchising. For example, California defines a "sub-franchisor" as "a person to whom a sub-franchise is granted" and "sub-franchise" as "any contract or agreement between a franchisor and a sub-franchisor whereby the sub-franchisor is granted the right, for consideration given in whole or in part for that right, to sell or negotiate the sale of franchises in the name or on behalf of the franchisor." The California Franchises Regulations provide that when the person filing the application for registration is a Sub-franchisor, the application also must include the same information concerning the Sub-franchisor as is required from the Franchisor.

Generally, the same disclosure obligations apply to the Sub-franchisor as to the Franchisor, which means the Sub-franchisor will be preparing and registering its own FDD, but its FDD will require some disclosures about the Franchisor. The FTC's Compliance Guide explains that both the Franchisor and any Sub-franchisor are responsible for each other's compliance with the FTC Franchise Rule and are jointly and severally liable for each other's violations. However, some of the required disclosures may need to be supplied by the Sub-franchisor only, or by the Franchisor only, and in other instances, both must supply the information so the disclosure is accurate. The Compliance Guide discusses the items of the FDD that particularly need addressing by one or the other, or both.

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All of the state franchise sales laws in one manner or another address the Sub-franchise relationship and require disclosure by the Sub-franchisor. The definition of "Sub-franchisor" in some states, like Illinois, may cover other relationships not involving the sale of a Sub-franchise but simply a negotiation of a sale.

C. Exemptions

There are numerous exemptions or exclusions from all of the state and federal franchise sales laws and regulations, but little uniformity. It is very likely that an exemption in one jurisdiction may not be available in other jurisdictions. However, there are two exemptions or exclusions that are common.

First, both the FTC Franchise Rule and all of the franchise sales states have adopted a bona fide wholesale price exemption or exception to the definition of franchise fee. This exemption or exception applies only to the purchase of goods, not services. The other exemption or exception adopted by the FTC and most of the states is a minimum required fee, usually at least $500, but less in some states. The FTC calls this a minimum payment exemption. Note, for purposes of the FTC Franchise Rule and the South Dakota Franchise Investment Law, there is an exemption for any franchise where the required payments within six months after commencing operation of the Franchisee's business is less than $500. It is possible that a franchise program not covered by the FTC Franchise Rule or the South Dakota law could be covered by the franchise sales laws of the other 14 states because they do not have a six-month grace period.

The FTC Franchise Rule has a number of other exemptions, including three sophisticated-investor exemptions, which may be described as follows:

1. A "fractional franchise" exemption, where the Franchisee or its directors or officers (or those of an affiliate) have more than two years of experience in the same type of business, and it is anticipated that sales from the relationship will not exceed 20% of the Franchisee's total dollar volume in sales during the first year of operation.
2. A leased department exemption, where an independent retailer sells its own goods and services leased from a larger retailer in the larger retailer's store.
3. The petroleum marketers' and resellers' exemption, for those parties covered by the Petroleum Marketing Practices Act.
4. The large franchise investment exemption, where the Franchisee's initial investment, excluding financing by the Franchisor and the cost of unimproved land, totals at least $1 million and the Franchisee signs an acknowledgment.
5. The large franchisee exemption, where the Franchisee (or its parent or any affiliate) is an entity that has been in business for at least five years and has a net worth of at least $5 million.
6. The "insider's" exemption, where one or more purchasers of at least a 50% ownership interest within 60 days of the sale has been, for at least two years, an officer, director, general partner, or an individual with management responsibility for the offer and sale of the Franchisor's franchises or the administration of the franchise network; or within 60 days of the sale, for at least two years, the owner of at least a 25% interest in the Franchisor.
7. Oral agreements, where there is no written document that describes any material term or aspect of the franchise.

The Original FTC Franchise Rule also had several exclusions relating to employer-employee relationships, general partner relationships, cooperative associations, certification or testing services, and single trademark licenses. Although those exclusions were not carried over to the amended FTC Franchise Rule, the FTC in its Compliance Guide says those relationships are still excluded from the Rule because none of them meet the definitional elements of the term "franchise" and should not be confused with a franchise relationship.

The states have a variety of exemptions and exclusions, but no state has exactly the same exemptions and exclusions as the FTC, although Illinois recently adopted many of them. For example, all but one of the franchise sales states would regulate a so-called oral agreement. Some of the state exemptions exempt the relationship from the state's registration and disclosure requirements, and other exemptions exempt the relationship just from the registration requirements.

A Franchisor would need to review the applicable state franchise sales laws to determine which exemptions may be available for its program. A large number of states have a statutory or regulatory fractional franchise exemption (10 states), a large franchisor

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exemption (9 states), and exemptions for sale by a Franchisee when the Franchisor is not involved or only has to provide its approval (15 states). Other exemptions that only some of the states have adopted include leased departments (7 states), cooperative associations (5 states), sophisticated or experienced purchasers (6 states), isolated or a limited number of sales (4 states), out-of-state sales (8 states), sales by an executive or trustee (7 states), petroleum wholesalers (2 states), banks (10 states), and sales to an existing franchisee (8 states). Some of these state exemptions require approval by the state franchise authorities or a notice filing before they can be implemented.

D. Discretion of Regulatory Authorities

The FTC and the states with franchise sales laws do not have discretion to determine whether a particular distribution or licensing arrangement is or is not a franchise, but the FTC and many of the states will, upon request, issue advisory or interpretive opinions as to whether they believe a particular distribution or licensing arrangement is or is not a franchise. Both the FTC and the states may take enforcement action against a seller that they determine is selling franchises in violation of the applicable franchise sales law or regulation.

As noted above, some of the state exemptions that require approval by the state franchise authorities are often described as discretionary exemptions. In many states, the franchise sales laws give the state franchise administrator some discretion to determine what information may have to be disclosed to certain classes of Franchisees. For example, the Illinois Franchise Disclosure Act (IFDA) provides that the administrator by rule or order can provide that any information required to be included in the FDD need not be included in respect of any class of Franchisees if the administrator finds that the requirement of such information is inapplicable to such class and that disclosure fully adequate for protection of prospective Franchisees is otherwise required to be included in the FDD. The administrator by rule or order can exempt any franchise, Franchisor, Sub-franchisor, or franchise broker from the disclosure and registration requirements if the administrator finds that enforcement of the IFDA is not necessary (1) in the public interest, or (2) for the protection of any class of prospective Franchisees, or (3) by reason of the investment involved, or (4) because of the limited character of the offering.

The California Franchise Investment Law (CFIL) exempts from the registration and disclosure requirements any other transaction that the commissioner by rule exempts as not being comprehended within the purposes of the law and registration of which the commissioner finds is not necessary or appropriate in the public interest or for the protection of investors.

E. Jurisdiction

The FTC Franchise Rule applies in connection with the offer or sale of a franchise to be located in the U.S. or its territories, unless it is exempted. The FTC Compliance Guide says the Rule does not cover the sale of franchises to be located outside of the U.S. and its territories. The FTC gives this example:

> [T]he amended Rule does not apply, for example, to the sale of a franchise to an American citizen living in Paris (or in Chicago), or to a French citizen in Paris, when the outlet will be located in Europe.

A footnote to the quote clarifies that limitation of the geographic scope of the amended franchise Rule is not intended to limit the FTC's jurisdiction, as it is set forth in section 5(a) of the FTC Act and section 3 of the U.S. SAFE WEB Act of 2006.

The 15 franchise sales states typically have expansive jurisdiction over franchise sales activities within their respective states or with respect to sales or offers made in their states or to their residents, but generally limit that jurisdiction when applying their registration and disclosure requirements. Generally, the states retain broad jurisdiction to deal with issues like fraud and misrepresentation, but voluntarily limit their jurisdiction over which Franchisors are required to register their franchises when selling franchises either to residents of the state or to be operated in the state. But this is just a generalization, and each state's jurisdiction needs to be examined. A few examples will be illustrative.

The CFIL provides that it is unlawful to offer or sell any franchise in California unless the offer of the franchise has been registered or is exempt. The law defines "sale" or "sell" as including every contract or agreement or sale of, contract to sell, or disposition of a franchise or interest in a franchise for value. "Offer" or "offer to sell" includes every attempt to dispose of, or solicitation or offer to buy, a franchise or interest in a franchise for value. An offer or sale of a franchise is made in California when

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an offer to sell is made in the state, or an offer to buy is accepted in the state, or if the Franchisee is domiciled in the state, or the franchised business is or will be operated in the state. However, California limits its registration and disclosure obligations. Another provision of the CFIL provides that any offer, sale, or transfer of a franchise, or of any interest in a franchise, to a resident of another state or any territory or foreign country is exempted from the registration and disclosure requirements if all locations from which sales, leases, or other transactions between the franchised business and its customers are made, or goods or services are distributed, are physically located outside the state. Although the registration and disclosure obligations would not apply to that type of sale, other portions of the CFIL would.

Under the IFDA, it is unlawful for any person to offer or sell any franchise required to be registered unless the franchise has been registered or exempt. "Offer" or "offer to sell" includes every attempt to offer to dispose of or solicitation of an offer to buy a franchise, any interest in a franchise, or an option to acquire a franchise for value. However, Illinois limits its registration and disclosure obligations. Another IFDA provision provides that no Franchisor may sell or offer to sell a franchise in Illinois without complying with registration and disclosure requirements if (1) the Franchisee is domiciled in the state or (2) the offer of the franchise is made or accepted in the state and the franchised business is or will be located in the state. Thus, while registration and disclosure obligation might not apply to a transaction where a Franchisor and Franchisee both located outside Illinois enter into a franchise agreement to operate a franchise in Illinois, other provisions of the IFDA would apply to that relationship, such as provisions prohibiting fraudulent practices.

All of the other franchise sales states have similar provisions not extending their registration and disclosure requirements extraterritorially, except for New York. The New York Franchises Act provides that it is unlawful to offer to sell or sell any franchise in the state unless and until the FDD is registered with the state. "Offer" or "offer to sell" includes any attempt to offer to dispose of, or solicitation of an offer to buy, a franchise or interest in a franchise for value. "Sale" or "sell" includes every contract or agreement of sale, contract to sell, or disposition of a franchise or interest in a franchise for value. An offer or sale is made in the state when the offer to sell is made in the state or an offer to buy is accepted in the state, or if the Franchisee is domiciled in the state, or the franchised business is or will be operated in the state. An offer to sell is made in the state when the offer either originated from the state or is directed by the offeror to the state and renewed at the place to which it is directed. An offer to sell is accepted in New York when acceptance is communicated to the offeror in the state.

Unlike California and Illinois, however, New York does not have an exemption for out-of-state transactions. One early federal district court case held that the New York Franchises Act did not violate the U.S. Constitution by regulating franchises that were not located in New York because the act specifically required a tie to New York to be applicable. Thus, the New York Franchises Act applies if the offer to sell or buy was either made or accepted in New York or the actual sale occurred in New York, regardless of where the franchise is located or the franchised business is operated. A New York franchisor would have to provide its New York–registered FDD to all prospective Franchisees, no matter in what state the Franchisee resides or where the franchised business will be operated, in addition to the FDD that may be required by the state where the Franchisee resides or operates its franchised business. Having a uniform, multistate FDD for New York Franchisors becomes important.

Most of the franchise sales states (including all with an advertising filing requirement) have an exception similar to the CFIL provision that an offer to sell is not made in the state merely because (1) the publisher circulates, or there is circulated on its behalf, in the state any bona fide newspaper or other publication of general, regular, and paid circulation outside the state during the past 12 months, or (2) a radio or television program originating outside the state is received in the state. [1]

1 Although it is beyond the scope of this chapter, 25 states and the FTC have adopted so-called business opportunity laws or seller-assisted marketing plan laws. Although the definitions vary significantly, generally if a seller makes certain representations or provides a marketing plan to enable the buyer to start a business and the buyer pays consideration for goods or services, there may be a business opportunity. Trademark association is not required. Most state business opportunity laws can apply to certain types of franchise programs because of the existence of the sale of a marketing program or sales program. Generally, however, Franchisors with federally registered trademarks or service marks or those that comply with the FTC Franchise Rule or local franchise disclosure laws are exempt from the state business opportunities laws. However, the exemption may not apply if the Franchisor makes financial performance representations in connection with its offering or offers to refund the buyer's money if the buyer is dissatisfied with the business opportunity. In several states—Florida, Kentucky, Nebraska, Texas, and Utah—it is necessary for a Franchisor to file a notice of exemption to avoid application of the business opportunities laws. In Connecticut, if the seller's trademark or service mark was registered after October 1, 1996, a copy of the trademark must be filed with the state to claim the exemption. In addition, some of the state business opportunity laws exempt franchises from coverage only if an FDD is delivered within a certain time period prior to taking money or signing contracts. If the seller does not have a federally registered trademark, compliance with the business opportunity laws may be required.

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II. Who Must Provide Disclosure?

A. Franchisor

Franchisors must prepare and furnish disclosure documents to prospective Franchisees. Franchisors are persons who grant franchises and participate in the franchise relationship with Franchisees. Franchisors are also jointly responsible with Master Franchisees to provide disclosure to prospective Sub-franchisees.

B. Master Franchisee

Master Franchisees, also known as Sub-franchisors, are persons who are granted the right to Sub-franchise third parties to operate the franchised business. A Master Franchisee is a party to the contract with the Sub-franchisee and must also provide disclosure.

A handful of states have taken the position that "development agents," persons who are involved in the sale of franchises and perform some post-sale obligations on behalf of the Franchisor but who are not party to the contract with the Sub-franchisee, are also required to provide disclosure.

C. Franchise Consultant/Agent/Broker

A third-party broker with no post-sale performance obligations is not required to provide disclosure to the prospective Franchisee. As noted above, a development agent may be considered a Sub-franchisor in some states.

Although they are not subject to disclosure requirements, franchise consultants, agents, and brokers may be considered franchise sellers and are the subject of certain prohibitions under the FTC Franchise Rule. They may not make claims that contradict information in the Disclosure Document or make misrepresentations to a prospective Franchisee.

A Franchisee who sells its own outlet is not considered to be a franchise seller.

D. Franchisor or Others in Master Franchise Arrangement

Whether or not a Franchisor is a party to the contract with the Sub-franchisee, it is jointly responsible with the Master Franchisee or Sub-franchisor for preparing and delivering disclosure to the Sub-franchisee. Because the Disclosure Document will contain information about both the Franchisor and the Master Franchisee, both parties should provide by contract that they will supply accurate and complete information and indemnify the other party for any deficiencies in the information provided.

III. Who Must Receive Disclosure?

A. Prospective Franchisees

A Franchisor may comply with its obligation to furnish a disclosure document to a prospective Franchisee by delivering it to an agent or representative of the prospective Franchisee, such as an attorney. The FTC Franchise Rule also provides that disclosure can be furnished to a company officer if the prospective Franchisee is a corporation.

Because state laws may be more restrictive, it is advisable to make sure that the disclosure is provided to an officer of a corporate Franchisee, all general partners of a Franchisee that is a partnership, and all managers of a Franchisee that is a limited liability company. Since an entity may not be formed at the time of disclosure delivery, the individual receiving disclosure should acknowledge receipt on behalf of him- or herself individually as well as on behalf of any entity to be formed.

B. Special Types of Transactions

A Franchisor need not provide a Disclosure Document to a Franchisee that is extending the term of its current franchise agreement. Similarly, if a Franchisee is renewing its franchise agreement and the form of franchise agreement is not changing, no disclosure is required under the FTC Franchise Rule. If, however, the Franchisor requires the Franchisee to enter into a new form of agreement as a condition to renewal, then the Franchisor must provide disclosure. State franchise laws also exclude the renewal or extension of an existing franchise agreement from definitions of franchise sales except that there is no interruption in the operation of the business and no material change to the franchise agreement.

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If a Franchisee is transferring its franchise, the transferring Franchisee is not required to provide the transferee with a Disclosure Document. If the Franchisor becomes involved in the transaction, that may trigger disclosure requirements. Merely approving or disapproving a transferee is not involvement that rises to the level of creating a disclosure obligation. Some state laws may vary, however. For example, in New York, the Franchisee is required to furnish the prospective purchaser with a copy of the Franchisor's Disclosure Document then currently registered with the New York Department of Law.

C. Exemptions

The FTC has determined that certain types of franchises do not require the protection that pre-sale disclosure affords a prospective Franchisee. The types of transactions that are exempt under the FTC Franchise Rule include: (1) those that require only minimal payments; (2) those involving large franchise investments; (3) transactions with sophisticated Franchisees; and (4) fractional franchises. See Section 1.C. above for more details.

State exemptions vary and may include exemption from registration only or exemption from both registration and disclosure. They are far from uniform. In addition to the types of exemptions described above, state laws often include an exemption for large and experienced Franchisors who meet certain net-worth tests and have been in business for a certain amount of time. Some states also have exemptions for high-net-worth Franchisees and experienced Franchisees. A few states have limited offering exemptions. See Section 1.C. above for more details.

IV. When Must Disclosure Be Furnished?

A. Timing for the Disclosure

The FTC Franchise Rule requires the Franchisor to deliver its current FDD to a prospective Franchisee at least 14 calendar days before the prospective Franchisee signs a binding agreement with the Franchisor or makes any payment to the Franchisor or its affiliate. In addition, if a Franchisor unilaterally and materially alters the terms and conditions of the franchise agreement or any related agreements, it must provide the prospective Franchisee with a copy of the revised agreement at least seven calendar days before the prospective Franchisee signs the revised agreement. This requirement does not apply to changes that result from negotiations initiated by the prospective Franchisee. A Franchisor must also furnish the FDD to a prospective Franchisee earlier than otherwise required if the prospective Franchisee reasonably requests a copy. Note, however, that this early disclosure is required only with respect to people who are actually prospective Franchisees and not to competitors, the media, academicians, or researchers. A prospective Franchisee is someone who is already in the sales process.

In addition, prior to delivering the FDD, the Franchisor must advise a prospective Franchisee of the formats in which the FDD is available as well as any conditions necessary to view the FDD in a particular format and any prerequisites to obtain the document in that format.

Some of the states that require pre-sale disclosure follow the FTC Franchise Rule. Indeed, NASAA has issued a Statement of Policy that makes adoption of these requirements simple. However, some states retain the disclosure requirements that previously were required by the Original FTC Franchise Rule. Some require that the FDD be provided 10 business days prior to the Franchisee's execution of an agreement or payment of consideration. Others require disclosure at the earlier to occur of the 10-business-day period or the first personal meeting between the Franchisor and Franchisee to discuss the possible purchase of the franchise. Finally, some states require that disclosure occur a shorter period of time prior to signing the agreement or paying consideration. Those requirements are preempted by the FTC Franchise Rule.

B. Letters of Intent

State and federal franchise laws do not directly address disclosure requirements triggered by execution of a letter of intent. The execution of a nonbinding letter of intent or one that is binding only with respect to confidentiality should not require prior disclosure. If the letter of intent is binding, however, disclosure should be provided within the requisite amount of time prior to signing the document.

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C. Methods of Delivery of a Disclosure Document

The FTC Franchise Rule contemplates that the FDD can be delivered in a number of formats and by a number of means. The available formats, prerequisites, and conditions must be disclosed to the prospective Franchisee before he or she is provided with access to the document.

The FDD is deemed delivered if it is hand-delivered, faxed, or emailed. Another method of transmitting the FDD is by providing directions to access the document on the Internet. While electronic delivery of the FDD is permitted, both the FTC Franchise Rule and the NASAA Statement of Policy Regarding the Electronic Delivery of FDDs provide for certain guidelines that the Franchisor must follow. The FDD must be delivered as a single, integrated document and must have no extraneous content. It may have no links to or from external documents or content and must be in a form that enables the recipient to store, retrieve, and print it. While some states have adopted similar types of provisions explicitly permitting electronic disclosure, as a practical point of view, any restrictions on providing the document electronically will be preempted by the Electronic Signatures in Global and National Commerce Act (ESIGN).

A Franchisor may also deliver the FDD in a paper format or on a CD-ROM. If it does so by U.S. mail, an extra three calendar days must be added to the 14-day disclosure period, beginning on the day of deposit in the mail.

D. Ongoing Disclosure Obligations

There are several circumstances under which a Franchisor is required to provide additional disclosure to a prospective Franchisee under the FTC Franchise Rule. The first of these requirements is that if the prospective Franchisee reasonably requests, the Franchisor is required to provide a copy of the most recent FDD and any quarterly updates before the prospective Franchisee signs a franchise agreement. If the prospective Franchisee does not request it, no disclosure is required under the FTC Franchise Rule, even if the FDD has been updated since its initial delivery to the prospective Franchisee. State laws may differ, however (see below).

If, however, the Franchisor makes a unilateral change to the franchise agreement, the Franchisor is required to provide any revised agreement at least seven calendar days before the prospective Franchisee signs it. This applies only if the change is unilateral and material and does not apply to changes that arise out of negotiations initiated by the prospective Franchisee. The FTC in one of its FAQs (found on the FTC's website, www.ftc.gov) has provided an example of the type of change that is unilateral and material. Fill-in-the-blank provisions, such as the designation of a protected territory or the designation of an interest rate, will trigger this pre-sale delivery requirement if the specific information to be included is not disclosed in the FDD.

There are also certain miscellaneous circumstances under which a Franchisor must provide additional information to a prospective Franchisee. If, for example, the Franchisor is selling a previously owned franchised unit now under its control, it must disclose additional information for that outlet for the last five fiscal years. This includes contact information for each previous owner, the time period when each previous owner controlled the outlet, the reason for each previous change in ownership, and the time periods during which the Franchisor retained control of the outlet. This information may be attached as an addendum to the FDD or may be provided as a supplement to that document.

Another circumstance under which additional information must be provided concerns the disclosure of franchise sellers involved in the specific transaction. If these individuals are identified after the FDD has been provided, the Franchisor still must deliver this information via the receipt to the prospective Franchisee. For example, a supplemental copy of the receipt can be delivered to the prospective Franchisee with the business card of the additional franchise seller stapled to it.

States that regulate the offer and sale of franchises have requirements that material information not be omitted from the FDD. While some of the states have time periods within which this information must be included in the FDD, it behooves the Franchisor to include any material change in the FDD prior to selling a franchise to avoid being subject to state franchise law provisions and common-law claims of fraud and misrepresentation. In states that require registration of franchise offerings, the changes to the FDD must first be filed as an amendment to the Franchisor's registration.

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V. Information to Be Included in Disclosure Document

The FTC Franchise Rule's disclosure format is accepted in all states that regulate offers and sales of franchises and is, therefore, the format of choice. Sources necessary to interpret the requirements of the FTC Franchise Rule are: (1) the FTC's Statement of Basis and Purpose; (2) the FTC website FAQs; (3) the FTC Compliance Guide; (4) the NASAA 2008 Guidelines; (5) the NASAA Commentary issued on April 27, 2009; and (6) the NASAA Multi-Unit Commentary issued on September 16, 2014. Following is information on FTC Franchise Rule disclosure requirements, together with indications of what state law variations may apply.

A. The Franchisor and Other Parties

A Franchisor must include the name and principal business address of the Franchisor, its parents, and any affiliates that offer franchises in any line of business or provide any products or services to Franchisees. In addition, the same information must be provided for any predecessor for the 10-year period immediately preceding the close of the Franchisor's most recent fiscal year. Predecessors are persons from whom the Franchisor acquired the major portion of its assets.

Master Franchisees must include this information about both the Master Franchisee or Sub-franchisor and the Franchisor.

A Franchisor must also disclose the name that the Franchisor uses, its agents for service of process, its type of business organization, and information about the business the Franchisee will operate.

The general market for the product or service the Franchisee will offer must be included, as well as any laws or regulations specific to the industry in which the franchised business will operate. Also, the Franchisor must generally describe the franchised business's competitors.

Finally, the prior business experience of the Franchisor, of any of the predecessors, and of any affiliates for which disclosure is required must be included. This information consists of the length of time each has conducted a business similar to the franchised business and the length of time each has offered franchises for this type of business. Also, the Franchisor must disclose whether or not any of these entities has offered franchises in other lines of business, and, if so, information about the number of franchises sold and the length of time the franchise in that line of business was offered.

B. Business Experience of Management of Franchisor

The principal positions and employers during the past five years must be disclosed for the Franchisor's directors, trustees, general partners, principal officers, and any other individuals who will have management responsibility relating to the sale or operation of the franchises. This information must include the starting date, ending date, and location of employment.

C. Litigation History

Litigation disclosure must be included for the following persons: (1) the Franchisor, (2) its predecessor, (3) a parent or affiliate who guarantees the Franchisor's performance or otherwise induces sales by promising to back the Franchisor financially, (4) an affiliate who offers franchises under the Franchisor's trademark, and (5) any management personnel identified in the previous section.

Franchisors must include pending litigation involving administrative, criminal, and material civil actions if the complaint alleges a violation of franchise, antitrust, or securities law, or alleges fraud, unfair or deceptive practices, or similar allegations. If there are other civil actions that are material in the context of the number of Franchisees and the size and nature or financial condition of the franchise system or business operations, they must be included. Ordinary routine litigation incidental to the business need not be disclosed.

In addition, certain past and concluded actions must be included if they were incurred during the 10-year period before the FDD was issued. These include a conviction or no-contest plea to a felony charge. They also include civil actions resulting in a requirement that the defendant pay money or other consideration, reduce indebtedness by the amount of an award, or be subject to a judgment that it cannot enforce its rights or must take adverse action. There is a materiality standard, and the civil action must have alleged violation of franchise, antitrust, or securities laws or have involved allegations of fraud, unfair or deceptive practices, or comparable allegations.

A summary description of material actions involving the franchise relationship must be included, whether these actions were brought by the Franchisor or by a Franchisee (although most Franchisee-initiated litigation will likely be covered by the requirements discussed above). These are actions concerning contractual obligations between the Franchisor and Franchisee directly related to the

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operation of the franchised business. They do not include actions involving suppliers or other third parties. Similarly, they do not include actions of indemnification for tort liability, and they must have occurred during the preceding fiscal year. These actions may simply be grouped in categories such as "Actions to Collect Royalties."

Currently effective injunction or restrictive orders or decrees brought by a public agency and relating to the franchise or to a federal, state, or Canadian franchise antitrust, trade regulation, or trade practice law must be disclosed if they apply to the Franchisor, a predecessor, a parent or affiliate guaranteeing the Franchisor's performance, an affiliate who has sold franchises in the line of business within the past 10 years, or any of the Franchisor's management personnel identified in the preceding section.

D. Bankruptcy

The FDD must include bankruptcy disclosure for actions filed under the U.S. Bankruptcy Code as well as under the laws of other nations. Disclosure is required of the Franchisor, its parents, predecessor, affiliate, officer or general partner, or any other individual who has management responsibility relating to the sale or operation of the franchise. The disclosure is confined to the preceding 10 years and includes disclosure for an individual who has been a principal officer or general partner in a company that filed as a debtor or obtained a discharge of its debts under the bankruptcy code within one year after the officer or general partner held the position in the company.

E. Initial Fees

Initial fees include all fees and payments or commitments to pay for services and goods received from the Franchisor or its affiliate before the Franchisee's business opens. It does not matter whether they are payable in a lump sum or by installments, although installment payment terms must be disclosed. The disclosure must include the amount of the initial fee and any conditions under which it is refundable. If initial fees are not uniform, the Franchisor must include the range or formula used to calculate the fee in the past fiscal year and the factors that determined the amount. The Franchisor need not disclose how it will apply the payment or whether commissions are due to any third party.

F. Other Fees

The FTC Franchise Rule requires disclosure in tabular form of other fees that must be paid to the Franchisor or its affiliate. This disclosure also requires disclosure of amounts that the Franchisor or its affiliate collects on behalf of a third party. Examples of the types of fees include royalties and fees for lease negotiations, construction, remodeling, additional training, advertising, audits, accounting services, inventory, transfers, and renewals. The amount and due date for each fee must be included as well as whether or not the fee is refundable and is uniformly imposed. Any formula for an increase in these fees or their maximum amount must also be disclosed.

G. Initial Investment

Franchisors are required to disclose the estimated initial investment to be made by prospective Franchisees. In addition to pre-opening expenses and other initial payments, a Franchisor must disclose an estimate of required expenses that the Franchisee will incur both before operations begin and during the initial period of operations. This initial period must be at least three months or a reasonable period for the industry in which the franchised business operates.

The disclosure must be in the form of a chart that requires a description of the type, amount, method of payment, due date, and payee. These types of fees are the initial franchise fee, training expenses, real property expenses, equipment, fixtures, other fixed assets, construction, remodeling, leasehold improvements and decorating costs, inventory, security deposits, utility deposits, business licenses, and other prepaid expenses as well as any other specific required payments that the Franchisee must make. A Franchisor can include a range of low and high estimates and can substitute certain disclosure if real property costs are too uncertain to estimate. This type of disclosure would be the approximate size of the property and building required and the probable location of the building, such as a strip shopping center, a mall, or a downtown location. Payments to third parties unaffiliated with the Franchisor must be included as well. There is no specific guidance to a non-U.S. Franchisor that has no operational or franchising experience in the U.S. Indeed, in determining the disclosure for additional funds that may be required, the Franchisor must describe the factors, basis, and experience that it considered or relied on in determining the estimate.

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Finally, the Franchisor must also state whether or not the Franchisor or an affiliate finances part of the initial investment, and if so, the amount required, down payment, annual interest rate, and estimated loan repayments.

H. Sources of Products and Services

Mandatory product and service source disclosure includes any restrictions on a Franchisee's ability to purchase or lease goods, services, supplies, fixtures, equipment, inventory, computer hardware and software, real estate, and comparable items. The restriction can include a designation by the Franchisor of a supplier (including itself or an affiliate). It can also include specifications and standards that are issued by a Franchisor to its Franchisees. The process for designating and approving suppliers and revoking that approval must be disclosed, along with information about any supplier in which an officer of the Franchisor owns an interest.

Another important aspect of the required disclosure is that of revenue or other material consideration which the Franchisor or its affiliates receive, either from the designation of suppliers or from required purchases or leases by Franchisees.

The Franchisor must also estimate the proportion that these restricted purchases and leases constitute of all of the goods or services that the Franchisee is required to obtain to establish and operate the franchised business. The existence of purchasing or distribution cooperatives must be disclosed as well as whether or not the Franchisor negotiates purchase arrangements with suppliers for the benefit of Franchisees.

Finally, any material benefits that the Franchisor grants to a Franchisee based on the Franchisee's purchase of particular products or services or use of particular suppliers must be disclosed. These could include an automatic renewal, the grant of additional franchises, or similar benefits.

I. Franchisee Obligations

The Franchisor is required to include a chart that lists a number of specified Franchisee obligations, such as site selection and development, pre-opening purchases, training, fees, trademarks and proprietary information, restrictions on products and services offered, warranty and customer service requirements, territorial development and sales quotas, ongoing purchase requirements, maintenance and remodeling, insurance, advertising, indemnification, owner participation in the franchised business, records and reports, inspections and audits, transfer, renewal, post-termination obligations, noncompetition covenants, and dispute resolution. The chart requires cross-reference only to the sections in agreements and the sections in the FDD that address these topics.

J. Franchisor Financing

Required disclosure includes both financing offered by a Franchisor or its affiliate and indirect financing, such as an agreement between a lender and a Franchisor to provide financing to the Franchisor's Franchisees. It also includes a Franchisor's guarantee of a note, lease, or other franchisee obligation.

This disclosure may be summarized in tabular form and must include what the financing covers, the identity of the lender, the amount offered, the interest rate plus finance charges, payment information, any security interest, any guarantees required, any prepayment penalty, potential liabilities on default, and other material terms.

Any waivers the Franchisee must make must also be included, along with information about the Franchisor's practice of selling, assigning, or discounting the financing to a third party.

K. Franchisor Obligations

Disclosure is required of the Franchisor's obligations. These are divided between pre-opening obligations and those required during the course of the franchise relationship. Specific information is required concerning advertising programs, computer systems, any operating manual that the Franchisor provides, and training programs.

The Franchisor's pre-opening obligations should be listed sequentially together with references to the agreement provisions that describe them. In particular, information containing site selection, the criteria for the Franchisor's approval of sites, and the typical length of time between signing the franchise agreement or paying consideration and opening the franchised business must be included.

Description of any other assistance during the operation of the franchise, such as developing products or services, resolving problems, and providing administrative, bookkeeping, accounting, and inventory control procedures must be included.

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A description of the Franchisor's advertising program must include the source of the advertising and any requirements that the Franchisor spend amounts in the Franchisee's area. Similarly, information about any advertising councils or cooperatives must be included. Information about whether other Franchisees must contribute a different amount or whether their contributions are calculated at a different rate is also required. Details on how the funds were spent in the most recently concluded fiscal year is another disclosure requirement, and many Franchisors use a chart to present this information.

If the Franchisor requires that the Franchisee purchase a computer system, the system must be described in non-technical language, including the cost of purchasing or leasing the system and information about ongoing maintenance, repairs, upgrades, or updates. In addition, the Franchisor must disclose whether or not it will have access to the data gathered by the Franchisee's computer system and whether or not there are any contractual limits on that right.

The Franchisor must also include the table of contents of any operating manual provided at the conclusion of its most recent fiscal year. The number of pages devoted to each subject and the total number of pages should also be included. As an alternative, if the Franchisor permits the prospective Franchisee to review the manual prior to signing the franchise agreement, the table of contents need not be included.

A chart outlining information about the initial training program that includes hours of classroom and on-the-job training and the location for training must be included, together with information about instructional materials, payment for training, and instructors and their backgrounds. Additional or supplemental training information must also be described.

L. Protected Territory

The FTC disclosure format specifies that a Franchisor must provide information about the location of the franchised business, any territory granted, conditions under which the Franchisor will approve relocation, and any options or rights of first refusal to acquire additional franchises. There is a specific disclaimer that must be included if the Franchisor does not grant an exclusive territory. An exclusive territory has been interpreted to be one in which the Franchisor agrees not to grant additional franchises or itself establish an outlet. The Franchisor's reservation of rights to offer its goods or services through other channels of distribution, even within the Franchisee's territory, does not affect the determination of whether or not the Franchisee is granted an exclusive territory.

Information about other channels of distribution, such as the Internet, catalog sales, telemarketing, and other direct marketing sales must also be included. Increasingly, Franchisors also include social media policy descriptions in this section.

Also required is information about soliciting or accepting orders outside of the Franchisee's territory, and detailed information must be included if the Franchisor or an affiliate operates or plans to operate another business under a different trademark that sells similar goods or services to those of the franchised business.

M. Trademarks and Domain Names

Required information about trademarks is confined to the principal trademarks, i.e., the primary trademarks, service marks, names, logos, and commercial symbols that the Franchisee will use to identify the franchised business. Although disclosure requirements state that this does not include every trademark the Franchisor owns, common practice is to include most or all of those trademarks in order to avoid arguments by Franchisees that a mark is not primary or important to the program. Application or registration information from the United States Patent and Trademark Office (USPTO) is required, along with current material determinations of the USPTO, the Trademark Trial and Appeal Board, any state trademark administrator, or any court. If a trademark is not registered, a specific statement concerning rights which the Franchisor may not have must be included. Disclosure of pending federal or state court litigation regarding the Franchisor's use or ownership rights in the trademark is required. In addition, any obligation on the part of the Franchisor to protect the Franchisee from claims that its use infringes the rights of others or constitutes unfair competition must be included, along with any obligation on the part of the Franchisee to notify the Franchisor if it discovers that a third party is using the marks. This section must also disclose any superior rights or infringing uses that could affect the Franchisee's use of the principal trademark.

No specific information is required concerning domain names, but restrictions on a Franchisee's right to operate utilizing a website or domain name that incorporates the Franchisor's mark is typically included here.

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N. Patents or Copyrights

Information about patents and copyrights must be included in the FDD. In addition, material determinations of the USPTO, the U.S. Copyright Office, or a court regarding the patent or copyright is required. A Franchisor must indicate whether it has an obligation to protect the patent or copyright or to defend the Franchisee against claims arising from the Franchisee's use of these items, as well as any conditions for such protection. In addition, the Franchisee's obligation to notify the Franchisor of any uses by a third party that it discovers must be included. Proprietary rights and other confidential information or trade secrets must be described in general terms.

O. Participation in Business

A Franchisee's obligation to participate personally in the on-premises supervision of the business must be included. If the Franchisee's personal participation is not required, then the Franchisor must include certain information about on-premises supervisors. Any equity interest that a supervisor is required to own in the Franchisee and the franchised business must be disclosed, together with any restrictions that the Franchisee must place on the manager, such as his or her obligation to sign a confidentiality and noncompetition agreement.

P. Restrictions on Sales

A Franchisor must disclose restrictions or conditions on the goods or services that the Franchisee must sell and also any obligation to sell only goods and services approved by the Franchisor or all goods and services approved by the Franchisor. The Franchisor's ability to make changes to these restrictions must also be described.

Q. Renewal, Termination, Transfer, and Dispute Resolution

Disclosure in tabular form is required for renewal, termination, transfer, and dispute resolution provisions in the franchise agreement. Unlike the chart outlining the Franchisee's obligations described in Section I. above, this chart must also summarize the provision and indicate its location in the applicable agreement.

In the renewal section, the Franchisor is required to state that Franchisees may be asked to sign a contract with materially different terms and conditions than the original contract if that is the case.

This disclosure is often modified in the states that require registration of franchise offerings. In particular, state laws may require that choice of forum be located within the state. In some cases, imposition of the local state law as governing law is also required.

R. Public Figures

If a public figure endorses or recommends the franchise to prospective Franchisees, the Franchisor must disclose any compensation that the public figure receives and whether the public figure is involved in management or control of the Franchisor. In addition, the public figure's total investment in the Franchisor must be disclosed.

S. Financial Performance Representations

Financial performance representations (FPRs) are not required by the FTC Franchise Rule. A financial performance representation means any representation that states expressly or by implication a specific level or range of actual or potential sales income, gross profits, or net profits. The Franchisor must include an opening paragraph in this section describing the fact that the FTC Franchise Rule does permit a Franchisor to make these representations, whether or not an FPR is presented. If the Franchisor chooses not to make an FPR, then it must add a second paragraph that cautions the prospective Franchisee on evaluating any information it does receive.

To make an FPR, a Franchisor must have a reasonable basis and written substantiation for the representation at the time it is made. It may be either a historical representation about the franchise system units or a subset of those units, or it may be a forecast or projection of possible financial performance. In both cases, a clear and conspicuous admonition that a new Franchisee's financial results may differ must be included. The Franchisor must also state that written substantiation is available to the prospective Franchisee upon reasonable request.

If the FPR is based on historical information, the Franchisor must state whether the representation reflects the data from all of the franchise system's units or only a subset of those units. If the FPR relates to a subset, the Franchisor must describe its set of

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characteristics, such as geographic location, type of location, degree of competition, length of operations, services or goods sold, services supplied by the Franchisor, and whether the units are operated by the Franchisor, its affiliate, or by Franchisees. In addition, the following must also be included: (1) the dates for the data; (2) the total number of units during the time period and the number that achieved the results, if different; (3) the number of units with the specific physical characteristics for which actual performance data was used; and (4) of these, the number of outlets that attained or surpassed the results.

If the FPR is a forecast of future financial performance, the Franchisor must include significant factors upon which the results are expected to depend, including economic or market conditions.

Actual operating results for a specific franchised outlet offered for sale do not need to be included in the FDD if the information is given only to potential purchasers of the outlet.

If a Franchisor furnishes an FPR in its FDD, then it may also provide a prospective Franchisee with a supplemental financial performance representation about a particular location or variation on the FPR.

These rules, and the requirement that any FPR be included in the FDD, also apply to representations made on the Internet and in other media.

T. Information on Outlets

A Franchisor must provide a series of five charts with information on outlets and Franchisees in the system for its past three fiscal years. The first chart is a summary of franchised and Franchisor-owned outlets that provides a snapshot of the size of the system during those three years. The second describes transfers from Franchisees to new owners other than the Franchisor. The third provides information on the status of franchised outlets, including openings, terminations, nonrenewals, outlets reacquired by the Franchisor, and those that ceased operations for other reasons. The fourth chart includes similar information for Franchisor- or affiliate-owned outlets. Finally, the fifth chart requires disclosure of franchise agreements signed but outlets not opened as of the Franchisor's most recently concluded fiscal year, projected new franchise outlets in the next fiscal year, and projected new Franchisor-owned outlets during that same period of time.

A list of current Franchisees and outlet contact information for each of them must be included, together with the names, cities, state, and current business telephone number of Franchisees who left the system during the preceding fiscal year.

U. Financial Statements

A Franchisor must include financial statements audited by an independent certified public accountant (CPA) using generally accepted U.S. auditing standards. The required financial statements include a balance sheet for the previous two fiscal year-end dates and statements of operations, stockholders' equity, and cash flows for each of the previous three fiscal years.

An affiliate's financial statements can be substituted if the affiliate guarantees the Franchisor's obligations. If the franchise offering is a Sub-franchise, financial statements are required for both the Franchisor and the Sub-franchisor. If a parent of the Franchisor commits to perform post-sale obligations for the Franchisor or guarantees the Franchisor's obligations, its financial statements must be included as well.

The FTC Franchise Rule permits start-up franchise systems that do not yet have audited financial statements to phase in the use of audited financial statements over a three-year period. State law may vary. Some state laws will permit a Franchisor to use financial statements that are not audited during the first year of registration but may require that audited financial statements be submitted after that. During the first year of registration, some states still require that the statements be reviewed by an independent CPA. Other states do not permit any phase-in whatsoever and require audited financial statements when the program is initially registered.

The financial statements of non-U.S. Franchisors may not be prepared in accordance with U.S. generally accepted accounting principles (GAAP). The FTC Franchise Rule also allows financial statements that are permitted by the Securities and Exchange Commission (SEC). The SEC currently permits financial statements prepared using accounting principles other than U.S. GAAP if prepared according to a comprehensive body of accounting principles. Those principles must be disclosed, together with material differences between U.S. GAAP and the other body of principles, which will likely include a reconciliation of some items. The Franchisor must also include all additional disclosures required by U.S. GAAP and applicable SEC regulations. Therefore, it is often easier for a non-U.S. Franchisor to form a U.S. subsidiary and take advantage of the phase-in provisions.

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V. Franchise Contracts

The Franchisor is required to attach a copy of each of the proposed agreements regarding the franchise offering, including the franchise agreement and any lease options and purchase agreements.

W. Receipt

Two copies of a mandated Receipt form must be included at the end of the FDD, with one copy to be signed and returned to the Franchisor and the other retained by the Franchisee. The Receipt advises the Franchisee about important information, such as delivery requirements. In addition, the franchise sellers involved in the specific transaction with the prospective Franchisee must be identified in the Receipt, including each of their names, principal business addresses, and telephone numbers. Some franchise sellers may be identified only after the Receipt has been returned to the Franchisor. In those cases, the Franchisor is nonetheless required to add its contact information and re-deliver a copy to the Franchisee. This does not trigger another 14-day waiting period. Since some franchise registration states require different periods of time between delivery of the FDD and the Franchisor's ability to sign an agreement with the Franchisee or accept consideration, additional language must be inserted in the Receipt describing these requirements if the offering will be made in one of these states.

X. Other Information/Documents

The Franchisor must also disclose whether any Franchisees signed confidentiality clauses during the last three years restricting them from speaking about their experiences as Franchisees. Certain information about trademark-specific Franchisee organizations is also required. An independent Franchisee association that is organized under state law may ask to be included in the Franchisor's disclosure document.

The FTC Franchise Rule states that a Franchisor should not include any materials or information other than that required by the FTC Franchise Rule or permitted by state law that is not preempted by the FTC Franchise Rule.

Some states will require additional information to be included in the FDD. Typically this is done by addendum and may include such items as cautionary language regarding the enforceability of certain provisions in the franchise agreement. State examiners may also require a Franchisor to include risk factors on the state cover page to the FDD.

Y. Other Legal Disclosures

Some states require that franchise relationship laws (e.g., restrictions on termination rights and nonrenewal rights) be described in the FDD.

Z. Material Information

State franchise laws require that a Franchisor disclose all information that is material to a prospective Franchisee and prohibit Franchisors from omitting such material information.

AA. Use of Supplemental Disclosure Documents

As noted in Section V.S. above, if a Franchisor makes a financial performance representation, it may make a separate supplemental financial performance representation that relates to a particular type of location or that presents a variation on the information presented in the FDD.

In addition, the Franchisor may present the quarterly updates to the FDD (see below) as an attachment or an addendum to the FDD or it may incorporate the information into the FDD itself.

If a Franchisor is selling a previously owned franchise outlet now under its control, it must disclose certain ownership information for the previous five fiscal years. This information may also be attached as an addendum or provided as a supplement to the FDD.

Finally, state-specific information is generally permitted as an addendum to the FDD, the franchise agreement, or other applicable documents.

BB. Updating Requirements

The FTC Franchise Rule's updating requirements include a mandate that the FDD be updated within 120 days following the fiscal year-end of the Franchisor. In addition, any material changes to the required disclosures must be made within a reasonable time after the close of each quarter.

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State law may require more frequent updates. Many state laws will require that material changes be disclosed "promptly" or immediately. Others require updates within a certain period of time, such as 30 days following the change. Therefore, it behooves a Franchisor to make any changes immediately if it is subject to the jurisdiction of any of these states.

VI. Governmental Filings

A. Initial Filing Requirements

The FTC Franchise Rule requires disclosure only, and there is no filing made with the FTC.

In all of the franchise sales states except Michigan and Oregon, the FDD must be filed with, and in most states registration must be ordered effective by, the state authorities before it can be used and before an offer or sale of a franchise can be made. The state franchise sales laws are administered by various administrative agencies within the states—in some states by the corporation or securities authorities, and in others by the state attorney generals.

In 13 states (the so-called "franchise filing states"), the Franchisor must submit to the applicable state authority an application package consisting of several forms adopted by NASAA in its 2008 Guidelines. In some states, additional or different forms are required. To register a franchise in the franchise filing states under the NASAA 2008 Guidelines, the following application documents would be filed by a Franchisor as required by the specific state:

1. Uniform Franchise Registration Application (Form A);
2. Franchisor's Costs and Sources of Funds (Form B);
3. Uniform Franchise Consent to Service of Process (Form C);
4. Franchise Seller Disclosure Form (Form D);
5. FDD;
6. Application Fee (varies by franchise filing state);
7. Guarantee of Performance (if required) (Form E);
8. Consent of Accountant (or a photocopy of the consent) to the use of the latest audit report in the FDD (Form F); and
9. Advertising or promotional materials (if required by the franchise filing state).

Some states do not require the use of all these forms or have adopted different forms, and some states require some of the documents to be notarized. Michigan requires only that a notice of sale be filed. Oregon requires only compliance with the FTC Franchise Rule and no filing or registration. Many of the franchise sales states have adopted administrative regulations that provide additional definitional guidance and procedures for registering and filing FDDs.

As of January 2015, the filing fees (in U.S. dollars) for an initial franchise registration range from $250 to $750 per state: California ($675), Hawaii ($125), Illinois ($500), Indiana ($500), Maryland ($500), Michigan ($250), Minnesota ($400), New York ($750), North Dakota ($250), Rhode Island ($600), South Dakota ($250), Virginia ($500), Washington ($600), and Wisconsin ($400). If a Franchisor with a federal trademark registration were to file in all the franchise filing states and in the six business opportunity states that require an exemption filing, the total filing fees would be $6,575.

As of the date this chapter was written, a number of states, including California, Washington, and Wisconsin, accept electronic filing of the FDD or application package. The NASAA 2008 Guidelines require FDDs to be submitted in both a paper copy and on a CD-ROM. Some states also want the application form on the CD-ROM, and one state wants only a CD-ROM.

B. Other Filing Requirements

There are no other filing requirements for any of the franchise sales laws. Other laws of general application may require other filings, such as those requiring an entity incorporated or organized in another jurisdiction to qualify to do business in a state under statutorily defined conditions.

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C. Discretion of Government Agency

When originally enacted, all of the state franchise sales laws required disclosure and registration, with review by the state franchise authorities. Since the late 1980s, five of the states have modified their statutes to eliminate their review process, one state no longer requires filing of an FDD, and some of the remaining states that review have reduced their oversight. On the other hand, a few states continue to take very aggressive action to review filed documents, and there is often little consistency in the comments a Franchisor is likely to get from these review states.

The states are required by statute to respond within defined time periods or the FDD will be automatically effective. In some of the nine franchise filing states that will likely review the FDD, if the state examiner cannot provide comments within the statutory time period, state examiners may ask the Franchisor to consent to an extension of the review period in order to avoid automatic effectiveness under the state franchise statute. A failure of the Franchisor to consent to an extension may result in a denial of the registration.

The state examiners in the nine states that review the FDD will provide differing levels of scrutiny, but the Franchisor can almost always expect to receive a number of comments from several of the state examiners. The Franchisor will have to respond to those comments and typically have to revise its FDD in order to receive the state approvals. In these states, it may take six weeks to six months to complete the registration process. The challenge for the Franchisor is to prepare one FDD that can be used in all the states because the comments will be various and will be coming at different times.

In order to be registered, many states require that the Franchisor have a substantial net worth and sufficient working capital to fulfill its pre-opening obligations to its Franchisees. As discussed in Section V., the FTC Franchise Rule requires that the Franchisor's or an affiliate's financial statements be attached to the FDD in Item 21. Generally these financial statements must be audited in accordance with U.S. GAAP, or as permitted by the SEC, but the FTC will allow unaudited financial statements to be used and audited financial statements phased in. The FTC Franchise Rule says the unaudited financial statements must be prepared in a format that "conforms as closely as possible to audited statements," and some states, like Illinois, require the unaudited statements to be "prepared by an independent CPA in accordance with GAAP." However, some of the states will not accept unaudited financial statements to be used, so a start-up Franchisor may have to use an audited opening balance sheet.

Some of the franchise filing states will review the financial statements to make sure that the Franchisor has sufficient net worth and working capital to be able to fulfill its pre-opening obligations to its Franchisees. The factors that are examined by the states are not prescribed by any statute, and only an Illinois regulation discloses what factors will be considered. If the state is not satisfied, it can require the Franchisor to deposit initial franchise fees into an escrow account until the franchised business opens, to defer collection of the initial franchise fee (and other payments to the franchisor) until the franchised business opens, or to post a bond or provide other satisfactory assurances of performance (e.g., a guarantee or a letter of credit), or to add risk factors to its state cover page. A state also could deny registration altogether.

Because the state approvals will come at different times, it is often difficult for a Franchisor to have one uniform, multistate FDD that can be used throughout the U.S.

D. Licensing of Brokers and/or Franchise Sales Personnel

The FTC Franchise Rule does not specifically require special disclosures regarding franchise brokers. However, the Rule does require that the Receipt pages of the FDD disclose the name, principal business address, and telephone number of each franchise seller offering the franchise. The Rule defines "franchise seller" as

> a person that offers for sale, sells, or arranges for the sale of a franchise. It includes the franchisor and the franchisor's employees, representatives, agents, sub-franchisors, and third-party brokers who are involved in franchise sales activities. It does not include existing franchisees who sell only their own outlet and who are otherwise not engaged in franchise sales on behalf of the franchisor.

The NASAA 2008 Guidelines require a Franchise Seller Disclosure Form to be filed with the application to register a franchise in the franchise filing states. The NASAA Instructions for Preparing the Franchise Seller Disclosure Form require that a form be completed for each person who may be engaged in soliciting or offering or selling the franchises for the Franchisor submitting the

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application. That includes the Franchisor's own employees, the employees of its parent or affiliates, and for any independent third party (e.g., broker) who may be providing sales services on its behalf. A few franchise filing states no longer require filing of the Franchise Seller Disclosure Form.

If an independent third party is used to solicit franchise sales, that person is a "franchise broker." Two states require the registration of franchise brokers (franchise sellers not employed by the franchisor or its affiliate). New York has a one-time registration requirement, and the state of Washington has an annual calendar-year registration requirement. In addition, a Franchise Seller Disclosure Form would be filed for the broker.

E. Ongoing Filing Requirements: Material Changes and Timing

The FTC and all of the states require prompt amendment of the FDD whenever a material change occurs in the information disclosed in the document. The FTC Franchise Rule requires Franchisors, within a "reasonable time after the close of each quarter of the fiscal year," to prepare revisions to the FDD to reflect any material change to the disclosures in the FDD or required to be in the FDD. This provision does not preempt the state material change amendment filing requirements and should not be viewed as a safe harbor for Franchisors. Most of the state laws do not have specific time periods within which the material change amendments must be made, although several states require that amendments be made within 30 days, and Illinois requires material changes to be made within 30 days after the close of each fiscal quarter. Most states simply require that the amendment be made promptly.

It would be prudent for a Franchisor with a multistate program to comply with the most restrictive of the state requirements and to file material change amendments promptly after they occur. The state statutes also vary on what constitutes a material change, but only about half the states define the term. If the change is material to a prospective Franchisee, i.e., a reasonable prospective Franchisee would find the information to be material in making a decision to purchase the franchise, common-law misrepresentation considerations may compel the prudent Franchisor not to wait until the FTC quarterly update is made to advise the prospective Franchisee of the change. Many of the state franchise examiners believe the antifraud provisions of the state statutes (discussed below) mandate revision of the FDD before another sale is made.

When preparing a material change amendment, the Franchisor will have to prepare and submit to the state-required material change application forms (those required by the NASAA 2008 Guidelines) as modified by the states, and clean and black-lined copies of the revised FDD. Indiana and South Dakota do not require that amendments to the FDD be filed with them, and there is no filing required in Michigan. In Illinois and Wisconsin, the amended FDD is effective on filing, and in Hawaii the amended FDD is effective seven days after filing. The other eight franchise sales states will review the material change amendment with varying degrees of intensity and may issue comments before the amendment is ordered effective. In Virginia, however, the Franchisor can get an optional automatic effectiveness by filing an Affidavit of Compliance. Even though the material change amendment is effective on filing in Illinois, the state often will review the material change amendment at a later date and provide comments many months after the filing became effective. This procedure has raised some concern about the effectiveness of franchise sales made between the time the amendment is filed and the comment received and responded to, but the Illinois franchise examiners do not consider such sales to be improper.

In the states where a material change amendment has to be filed, as of January 31, 2015, the filing fees range (in U.S. dollars) from $50 to $250 per state: California ($50), Hawaii ($125), Illinois ($100), Maryland ($100), Minnesota ($100), New York ($150), North Dakota ($50), Rhode Island ($120), Virginia ($100), Washington ($100), and Wisconsin ($200). If a Franchisor filed in all the states that require a filing, the fees would total $1,195.

The FTC Franchise Rule allows material change amendments to be made in the text of the FDD or in an addendum to be attached to the FDD. Historically, material change amendments were made in the text of the UFOC. It is not clear whether all of the franchise filing states will accept a material change amendment made in an addendum to be attached to the FDD.

The FTC Franchise Rule does not address the issue of whether franchise sales can continue while the FDD is being revised to reflect a material change. It simply says that the Franchisor must prepare revisions within a reasonable time after the close of each quarter of the fiscal year to reflect any material changes, and each prospective Franchisee is to receive the FDD and the quarterly revisions for the most recent period applicable at the time of disclosure.

In FAQs #24, the FTC addressed the issue of whether the FTC Franchise Rule is violated if a prospective Franchisee requests an FDD, but applicable state law prohibits the Franchisor from providing its FDD to the prospect until an amendment has been filed

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with or made effective by the state. In FAQs #14, the FTC had said that the FTC Franchise Rule does not require a Franchisor to update its disclosure continuously or immediately upon every new occurrence, or to stop selling until it has updated its disclosure. In FAQs #24, the FTC said that "the same cannot be said for state franchise investment laws."

Most state franchise sales laws do not directly address the issue of whether franchise sales can be made while a material change amendment is pending. The Franchisor may be able to complete a pending sales transaction based on disclosure made with the currently registered FDD if the disclosure was made prior to filing the material change amendment and if the material changes are not significant to the particular transaction. Most franchise lawyers will advise their Franchisor clients to cease sales activities while a material change amendment is pending and to re-disclose to prospective Franchisees when the material change amendment is approved by the state. Only a few states have specific rules for making sales while a material change amendment is pending.

F. Ongoing Filing Requirements: Annual Updates and Timing

The FTC Franchise Rule requires annual updating within 120 days after the Franchisor's fiscal year-end, including the first quarter's material change update. Typically, the state franchise registrations are effective either for a period of one year or until a certain time after the end of the Franchisor's current fiscal year, and must be updated or renewed or an annual report filed before the expiration date of the current registration or within a certain time period after the Franchisor's fiscal year-end. Many Franchisors try to have all of their annual renewals or reports placed on the same cycle coordinated to a certain time period after the Franchisor's fiscal year-end.

Some of the states, like Illinois, Minnesota, New York, and Rhode Island, require updating or filing an annual report within 120 days after the Franchisor's fiscal year-end, and California requires updating within 110 days after the Franchisor's fiscal year-end, but the other states have varying expiration dates. Hawaii's registration expires three months after the Franchisor's fiscal year-end, and many state registrations are effective for one year. In South Dakota, the registration is effective for one year, but the FDD must be updated within 120 days after the fiscal year-end (no filing is made with the state). Some states require that the renewal package be submitted within a set number of days, anywhere from 15 to 30 business days before the registration expiration date, to ensure that the renewal application will be processed in an orderly fashion.

Each of the states requires that the NASAA application package discussed in Section VI.A. above (as modified by local requirements) be submitted on renewal, together with clean and black-lined copies of the FDD. The FDD must be updated to include the fiscal year-end information required by the FTC Franchise Rule, including audited financial statements as of the Franchisor's last fiscal year-end. Most of the states also require the filing of an auditor's consent form allowing the audit report to be used in the FDD. In some states, the audited financial statements must be current within 90 or 120 days of the filing, and if they are not, unaudited financial statements as of a date within 90 or 120 days will also have to be included in the FDD.

An annual renewal or report is required in all of the franchise filing states. The fees (in U.S. dollars) range from $100 to $450 per state: California ($450), Hawaii ($125), Illinois ($100), Indiana ($250), Maryland ($250), Michigan ($250), Minnesota ($300), New York ($150), North Dakota ($100), Rhode Island ($300), South Dakota ($150), Virginia ($250), Washington ($100), and Wisconsin ($400). If a Franchisor with a federally registered trademark filed in all 14 filing states and the two business opportunity states that require an annual exemption filing, the filing fees would total $3,375.

The states have differing time periods within which the renewal will be effective. In Illinois, Indiana, South Dakota, and Wisconsin, the renewal is effective on filing. (Wisconsin is technically a new registration each year.) Illinois is in the unique position of being a notice filing state for renewals or amendments, but not for initial filings, which are still subject to a registration and review process. However, the state still reviews the annual filing, sometimes many months after it is filed, and may provide comments at a later date. In Michigan, a Franchisor simply files an annual notice of sale. In Hawaii, the renewal is effective seven days after filing. The other eight franchise filing states are likely to review and comment on the annual update of the FDD. The renewal will not be effective in those states until the state issues its order of effectiveness.

Only a few of the franchise filing states have specific rules relating to continued sales while a renewal application or annual report is pending. In some states, a Franchisor may be able to close a deal on the terms of the previously provided FDD if it does so before the current registration expires. If the current registration expires before a renewal order is issued, however, all sales activity must stop.

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G. Filing or Registration of Executed Documents

Neither the FTC nor any of the franchise sales states requires the filing or registration of executed documents.

However, Maryland requires that all registered Franchisors provide a quarterly sales report of franchises sold, with certain details of the transaction. Hawaii and New York require an annual sales report of franchises sold with certain sales details.

VII. Other Requirements

A. Language Requirements

The FTC Franchise Rule requires all required information in the FDD to be disclosed in "plain English," which is defined as "the organization of information and language usage understandable by a person unfamiliar with the franchised business. It incorporates short sentences; definite, concrete, everyday language; active voice; and tabular presentation of information, where possible. It avoids legal jargon, highly technical business terms, and multiple negatives."

None of the state franchise sales laws has a similar requirement, but the FTC Franchise Rule would be controlling with respect to the FDD.

B. English Language

Although English is the required language for the FDD and contracts to be signed, a few recent court decisions have held that a person whose principal language is not English may require the FDD in that person's language. This raises an unrelated question of whether such a foreign-language FDD would comply with the FTC Franchise Rule and franchise sales state registration and disclosure requirements, since the foreign-language FDD would not be registered and approved by the states.

C. Filing of Trademark Licenses

There is no requirement that trademark license agreements or "registered user agreements" for trademark licenses be filed with any federal or state agency, such as the U.S. Patent and Trademark Office.

VIII. Franchisor-Franchisee Relationship Laws

A. Applicable Laws and Regulations

There are 24 states, plus two U.S. territories, that have passed laws which in one way or another regulate some aspect of the relationship between Franchisors and their Franchisees, particularly with respect to the termination or nonrenewal of the relationship, and two other states that regulate only a distributorship relationship. The jurisdictions with some type of relationship law include Alaska, Arkansas, California, Connecticut, Delaware, Hawaii, Idaho, Illinois, Indiana, Iowa, Louisiana, Maryland, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, North Dakota, Rhode Island, South Dakota, Virginia, Washington, Wisconsin, Puerto Rico, and the Virgin Islands.

The scope of coverage of these laws varies considerably. Some of the earliest state laws passed, and the laws of Puerto Rico and the Virgin Islands, apply generally to just about every selective distribution relationship, including franchises. However, many of the more recently adopted laws often use a definition of "franchise" similar to that used in the franchise disclosure laws and thus would not apply to the typical distribution arrangement. Each state's definition must be examined to determine its scope of coverage.

For example, the California Franchise Relations Act uses the same definition of "franchise" used in its franchise registration and disclosure law. In Illinois, the relationship law is physically incorporated into the Illinois Franchise Disclosure Act of 1987, so the same definition applies. As a result, these laws would apply to the typical uniform business format or package franchise, but would not apply to the typical distribution agreement if the seller does not require a fee to be paid by the distributor.

On the other hand, Connecticut, Missouri, Mississippi, New Jersey, Rhode Island, and Wisconsin have laws of broad application, as do Puerto Rico and the Virgin Islands. For example, the Connecticut Franchises law covers "franchises," which are defined as a Franchisee being granted the right to offer, sell, or distribute goods or services under a marketing plan or system

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prescribed in substantial part by a Franchisor, and the operation of the business pursuant to the plan is substantially associated with the Franchisor's mark or trade name. No fee is required.

The New Jersey Franchise Practices Act covers "franchises," which are defined as written arrangements in which one person grants to another person a license to use a trade name, trademark, etc., and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease agreement, or otherwise. However, the act applies only to a franchise that contemplates or requires a place of business in New Jersey, where gross sales of the products or services covered by the franchise exceed $35,000 for the prior 12 months, and where more than 20% of the franchisee's gross sales are derived from the franchise.

The Wisconsin Fair Dealership Law and the Rhode Island Fair Dealership Act apply to "dealerships," which are defined as expressed or implied agreements, oral or written, by which a person is granted the right to sell or distribute goods or services or use a trade name, trademark, etc., in which there is a community of interest in the business of selling or distributing goods or services at wholesale, retail, by lease, agreement, or otherwise. These laws have been held to apply to many typical authorized dealer or selected wholesaler or distributor relationships as well as franchises.

The Alaska law regulates the relationship between a distributor (defined as a wholesaler, manufacturer, and related entities who provide merchandise or services to a dealer) and a dealer, and the Maryland law covers grantors and their distributors (persons whose primary business is the wholesale distribution of commercial goods for resale and who maintain an inventory).

The relationship laws vary considerably in the subject areas regulated. Many of the laws deal with the relationship between the Franchisor and Franchisee during the term of the agreement and cover matters such as the right of the Franchisee to associate with other Franchisees of the Franchisor, competition by the Franchisor, and a ban on discriminatory treatment.

Some of the laws, such as the Missouri and Mississippi statutes, which have very inclusive definitions of what constitutes a "franchise," require only 90 days' notice to cancel, terminate, or fail to renew a franchise. Most of these laws, however, including those in Connecticut, New Jersey, Rhode Island, and Wisconsin, deal with the ability of the seller/manufacturer/Franchisor to end the relationship with the distributor/dealer/Franchisee. Typically, the agreement can only be terminated or not renewed for "good cause," as that term is defined in the statute. There usually must be notice given within a specified time before the termination, cancellation, or nonrenewal takes place; for example, 90 days in Wisconsin and 60 days in Connecticut and New Jersey. In California, the notice period is 30 days for termination and 180 days for nonrenewal. In Wisconsin and Rhode Island, the notice requirements also apply to a substantial change in the competitive circumstances of the agreement. Often, the distributor/dealer/Franchisee must be given the right to cure the alleged deficiency.

There is also often a provision requiring the Franchisor to repurchase the Franchisee's inventory, if the termination actually takes place, at a price specified in the statute, such as "fair wholesale market value." Some laws also permit the heirs of the Franchisee to inherit the agreement and continue the relationship indefinitely. Under the California law, a Franchisee that has received a notice of nonrenewal has the right to sell its business to a person meeting the Franchisor's current requirements.

The Connecticut Franchises law requires that a franchise must have a term of not less than three years and successive terms of not less than three years unless cancelled, terminated, or not renewed, as provided in the statute.

Efforts have been made several times over the years to adopt a federal relationship law. In fact, bills have been introduced and hearings held in Congress frequently. The definition used in most of those proposed federal bills has been broad enough to regulate most franchising and many selective distribution arrangements. No bill has passed Congress so far because of substantial opposition from the industry and many Franchisors and Franchisees.

B. Remedies for Violation

The relationship laws typically provide a private remedy for the Franchisee, whether the law is incorporated physically within the franchise sales law or is a free-standing statute.

If the agreement is terminated by the Franchisor without complying with these laws, the Franchisee is usually given the right to sue for damages and/or injunctive relief and generally can recover attorneys' fees in addition. The net effect of some of these laws often means that the relationship will exist for as long as the Franchisee (and the heirs of its owners) may want, as long as they continue to comply with the terms of the franchise or distribution agreement, until the agreement expires of its own force without renewal rights.

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C. Other Applicable Relationship Requirements

There are no other applicable relationship requirements. Interestingly, many of the relationship laws that are not part of the state's franchise sales law do not have anti-waiver provisions.

There are also laws that relate to specific industries, such as wholesalers or dealers selling motor vehicles, petroleum products, farm and industrial equipment, lawn and garden equipment, outdoor power equipment, hotels, campgrounds, marine products, or liquor, wine, or beer. For example, automobile dealership relationships are regulated by the Federal Automobile Dealer Franchise Act (often called the "automobile dealer day-in-court" law) and 50 separate state laws. Gasoline station operations are covered by the Federal Petroleum Marketing Practices Act and 42 separate state laws. Farm machinery dealerships are covered by 45 state laws; recreational vehicle dealerships are subject to five state laws; and liquor, beer, and/or wine distributorships are regulated by 45 state laws.

D. Statute of Limitations

There is no uniformity in the period for commencing legal action, and the applicable statute must be reviewed. If the relationship provisions are part of the state's franchise sales law, that statute will control the limitations period. See Section IX.D. below. In the states that have separate relationship statutes, some have specific time periods within which an action can be brought (for example, Indiana says actions must be brought no more than two years after the violation), but others do not specifically address the issue. In the latter situation, the state's general statute of limitations provisions would have to be reviewed.

IX. Violations of Franchise Sales Laws

A. Penalties for Failure to Comply with Disclosure Laws

Failure to comply with the FTC Franchise Rule is a violation of Section 5 of the FTC Act, subjecting violators to civil penalties of up to $16,000 per violation. Section 5 provides that "[u]nfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affecting commerce, are hereby declared unlawful." The FTC can enter cease-and-desist orders after administrative hearing procedures, or can sue in federal court for preliminary and temporary injunctions, restraining orders, and permanent injunctions. The FTC also can bring civil actions to obtain orders of rescission or reformation of contracts, refunds and damages, and criminal actions in an appropriate case.

Violation of the state franchise laws can occur in various ways: for example, failure to register with the state prior to offering or selling a franchise, not complying with the disclosure requirements of the FTC Franchise Rule as modified by the states, or making untrue statements or false representations in the FDD. Penalties can include administrative, civil, and criminal action by the state. For example, in Illinois, under the IFDA, the state can seek civil penalties in a sum not to exceed $50,000 per violation and can criminally prosecute any person who willfully sells a franchise without complying with the IFDA. In addition, the administrator can suspend, terminate, prohibit, or deny the sale of any franchise or registration of any franchise under certain circumstances, and can use the state's attorneys in the counties to prevent and restrain violations of the IFDA or any sale.

B. Who Is Liable?

Under the FTC Franchise Rule, the FTC can take enforcement action against any business entity that violates the Rule, and also against officers and directors of the entity if they controlled the wrongful conduct and had knowledge of the violation.

At the state level, the franchise filing states may take action against the entity and anyone involved in violating the law. For example, in Illinois, under the IFDA, the state can seek civil penalties against any person, trustee, manager, or other officer or agent of the corporation, or the corporation itself. Criminal actions can be brought against any person who willfully sells a franchise in violation of certain sections of the IFDA. With respect to civil actions, every person who directly or indirectly controls a person liable under the private remedy section, including partners in a partnership, every principal executive officer or director of a corporation, every manager of a limited liability company or person occupying a similar status or function, and every employee who materially acts in the act or transaction constituting the violation is jointly and severally liable, unless that person had no knowledge or reasonable basis to have knowledge of the facts, acts, or transactions constituting the alleged violation.

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Each of the state franchise sales laws has an anti-waiver provision that prohibits a Franchisor from requiring a Franchisee, as a condition of acquiring a franchise, from waiving the applicable state law. For example, in Illinois, under the IFDA, any provision purporting to bind any person acquiring any franchise to waive compliance with any provision of the IFDA or any other law of the state is void. The FTC Franchise Rule says it is an unfair or deceptive practice for any franchise seller to disclaim, or require a prospective Franchisee to waive reliance on, any representation made in the FDD or in its exhibits or amendments.

C. Who May Bring a Legal Action?

The FTC Franchise Rule does not provide a private right of action to a Franchisee. Only the FTC can institute enforcement actions. However, in several states, Franchisees have successfully sued Franchisors for rescission or damages under the state's "Little FTC Act" (deceptive trade practices act) for violation of the FTC Franchise Rule.

As noted above, the states can take administrative or court action against the Franchisor. In addition, the state statutes usually give the Franchisee the right to sue for damages and/or rescission if the law is violated. The Franchisee can seek damages or injunctive relief and usually can recover attorneys' fees.

Most of the state franchise sales laws preserve for the Franchisee the right to take action for violation of the laws in the courts of that state. For example, in Illinois, under the IFDA, any provision in a franchise agreement that designates jurisdiction or venue in a forum outside the state is void, except that the franchise agreement can provide for arbitration outside of the state.

D. Time Period for Commencing Legal Action

With respect to a violation of the FTC Franchise Rule, there are varying time periods within which the FTC must take action. If a company violates a cease-and-desist order, the FTC can seek civil penalties within five years. For a redress action with regard to conduct that violates a trade regulation rule or constitutes unfair or deceptive behavior, the FTC must file within three years after the conduct occurred. For violations of Section 5 of the FTC Act (under which the FTC Franchise Rule was promulgated, and pursuant to which the FTC usually takes action), however, there is no statute of limitations, but the courts will apply the equitable doctrine of laches to determine whether the FTC claim has been made timely. If a Franchisee tries to institute action for violation of the FTC Franchise Rule under a state's Little FTC Act, it will have to determine that state's statute of limitations.

The statute of limitations for action by the states or by private parties under the franchise sales laws is usually contained in the state's franchise sales laws and varies considerably by state. Franchisors can shorten the limitations period in some states by providing a notice of violation to a Franchisor. For example, in Illinois, under the IFDA, a private action by a Franchisee must be commenced before the expiration of three years after the act or transaction constituting the violation, the expiration of one year after the Franchisee becomes aware of facts or circumstances reasonably indicating that it has a claim for relief, or 90 days after delivery to the Franchisee of a written notice disclosing the violation, whichever shall first expire. The state must bring actions for civil penalties within three years after commission of the act upon which it is based, and criminal actions within three years after commission of any offense. The state takes the position that there is no statute of limitations with respect to administrative actions.

In California, under the CFIL, a private action must be brought before the expiration of four years after the act or transaction constituting the violation, the expiration of one year after discovery by the plaintiff of the facts constituting the violation, or 90 days after delivery to the Franchisee of a written notice disclosing any violation if the notice has been approved as to form by the Commissioner of Business Oversight, whichever shall first expire. The state can bring actions for civil penalties before the expiration of four years after the act or transaction constituting the violation, and can refer evidence of a criminal violation to the appropriate district attorney for the county in which the violation occurred, but the CFIL does not address the statute of limitations period, which will be governed by the criminal code.

E. Misrepresentations

The FTC can take action to protect consumers who have been injured by misrepresentations made by Franchisors.

State franchise sales laws typically have prohibitions on a Franchisor making misrepresentations when offering or selling a franchise that may apply to a Franchisor with connections to the state, even if the registration and disclosure requirements do not apply to that sale. See Section I.E. above. These claims are governed by the same rules as other violations of those state laws.

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F. Enforcement by Government

As described in Sections IX.A through E above, both the FTC and the states with franchise sales laws can pursue administrative, civil, and, in appropriate cases, criminal action against persons violating the applicable disclosure requirements.

G. Judicial Trends

Over the course of franchising in the U.S., different issues have dominated court proceedings involving the franchise relationship at different stages in the development of franchising, such as issues relating to antitrust, the specification of approved suppliers, vicarious liability, and use of marketing or advertising funds. As of January 2015, the judicial issues that seem to be of most interest to the franchise community include (1) vicarious liability of Franchisors for acts by Franchisees or their personnel; (2) whether a Franchisor is the joint employer of the Franchisee's employees; (3) whether a Franchisee can be characterized as an employee for purposes of state labor, workers' compensation, unemployment, or other laws; and (4) whether a Franchisor with no place of business in a state can be responsible for paying income or sales taxes to that state simply because it has a Franchisee operating in the state.

About the Authors*

The late **John Baer** was an officer in the Chicago, Illinois (U.S.A.) office of Greensfelder, Hemker & Gale, P.C. Mr. Baer had extensive experience representing domestic and international companies engaged in franchising and distribution. A frequent speaker and writer on franchise topics, John was extremely active in several organizations. In 2011 and 2012, he was chair of the International Franchising Committee of the International Bar Association's International Sales, Franchising and Product Law Section. He recently served as co-editor of the *International Journal of Franchising Law*. John was chair of the Illinois Attorney General's Franchise Advisory Board from 1996 to 2012, a member of the Industry Advisory Committee to the North American Securities Administrators Association Franchise Project Group from 2007 to 2010, a member of the ABA Forum on Franchising Governing Committee from 2003 to 2008, and editor of the *CCH Sales Representative Law Guide* from 1997 to 2011. John's franchising work garnered him frequent recognition in publications such as *Chambers, Best Lawyers in America, Franchise Times*, and the *International Who's Who of Franchise Lawyers*. In 2008, he was the first recipient of the prestigious Lewis G. Rudnick Award from the ABA Forum on Franchising.

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