



Lathrop GPM LLP
lathropgpm.com

80 South 8th Street
500 IDS Center
Minneapolis, MN 55402
Main: 612.632.3000

600 New Hampshire Avenue, N.W.
The Watergate – Suite 700
Washington, D.C. 20037
Main: 202.295.2200

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Via E-mail: NASAAComments@nasaa.org

North American Securities Administrators Association
Corporation Finance Section and
Franchise and Business Opportunities Project Group
c/o NASAA
750 First Street NE
Suite 1140
Washington, D.C. 20002

Attention: Andrea Seidt (Andrea.Seidt@com.state.oh.us)
Dale Cantone (DCantone@oag.state.md.us)

RE: Response to “Proposed Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments”

Dear Project Group Members:

This letter is being submitted on behalf of the law firm Lathrop GPM LLP (“Lathrop GPM” or the “Firm” or “we”) in response to the request of NASAA’s Franchise and Business Opportunity Project Group (the “Project Group” or “NASAA”) for comments on its “Proposed Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments” (the “Proposal”), released on December 6, 2021. We provide below a brief synopsis of Lathrop GPM’s experience and then our comments on the Proposal. We appreciate the opportunity to submit these comments and also appreciate the Project Group’s efforts in ensuring the integrity of the franchise sales process.

I. The Lathrop GPM Franchise Group

Lathrop GPM is a full-service law firm operating from 15 offices in the United States, with a diverse franchise practice group consisting of more than 25 attorneys and paralegals who devote all or a majority of their practice to franchising, licensing, and distribution. Lathrop GPM franchise lawyers represent many of the most famous brands in all aspects and industries in franchising, as well as start-up and emerging brands, franchisors entering the U.S. from abroad, and U.S. franchisors that are franchising internationally. We currently represent more than 350 clients or brands in franchising, licensing, and distribution, in more than 60 industries, and annually prepare or review more than 175 FDDs. Franchising is a core practice of Lathrop GPM.

Lathrop GPM franchise lawyers have more than 300 years of franchise law experience, acquired principally from representing franchisors and master franchisees. Members of our team have been active participants in the development and interpretation of the FTC's Franchise Rule, state franchise disclosure laws and regulations, the UFOC (and now the FDD) and its Guidelines, and NASAA Commentaries. Members of our firm's Franchise and Distribution Law practice group have submitted comments on every NASAA proposed policy or comments. In 2019, we submitted comments in response to the Federal Trade Commission's request pertaining to its decennial review of the Rule, and participated in the FTC's November 10, 2020 Workshop on the FTC Rule, which addressed some of the issues in the current NASAA Proposal.

Our franchise litigation team regularly engages in the defense of claims which assert FTC Rule and state disclosure law violations. Members of our franchise team have authored and delivered several hundred articles and presentations on the FTC Rule, U.S. franchise disclosure laws, and franchise and distribution issues since the FTC Rule was first proposed.

II. Comments on the Proposal

A. Summary of our Position.

Lathrop GPM believes that the Proposal is unwarranted, and should be either withdrawn, or revised substantially, subject to more detailed and open discussion and research with all interested parties. Our position, which is discussed in detail in this letter, is that the Proposal:

(i) fails to fully acknowledge the benefits of Questionnaires and Acknowledgments, and proposes to reduce or eliminate these benefits;

(ii) is based on misunderstandings of the judicial decisions concerning Questionnaires and Acknowledgments, as well as waivers, releases, disclaimers, and non-reliance clauses; and

(iii) is based on faulty and/or unsubstantiated assumptions regarding franchisor practices and policies among the vast majority of franchise systems.

Further, the implementation of the Proposal by state franchise examiners will harm the franchise sales process, will be detrimental to both franchisees and franchisors, and is contrary to the purpose and intent of the state franchise disclosure laws. Finally, if implemented by individual state regulatory agencies, the Proposal will impermissibly expand any permitted "interpretation" of franchise statutes, and will effectively create new franchise disclosure rules and laws. Such substantial revisions to the law are properly the subject of legislation or proper administrative rule making procedures, not implicit delegation to a Project Group.

Lathrop GPM recommends the following:

1. NASAA at a minimum should provide an expanded comment period, due to the short, 30-day period for comment that occurred over the 2021 winter, Christmas, and New Year's holiday season. The need for an expanded comment period is particularly acute because the primary medium by which affected constituencies (that is, franchisors, franchisees, and their counsel) would ordinarily learn of the Proposal – the ABA Forum on Franchising's list serve (also known as "Franchising Connection") – was inoperable during the comment period.¹

2. The Proposal should be scaled back dramatically, as follows: (a) to not prohibit the use of Questionnaires and Acknowledgments or specific factual statements or responses to factual questions; (b) to recognize that Questionnaires and Acknowledgments that appear outside of a franchise agreement are relevant and material information that should be part of Item 22 of an FDD, so that a prospective franchisee has notice of a franchisor's expectations very early in the franchise offer and sales process; and (c) to modify the proposed statement that the Proposal seeks to require in the FDD, franchise agreements and state addenda, as set forth in Part II.C.3 of the Proposal.

3. The Project Group should specifically acknowledge that the recommendations in the Proposal are not simply "interpretations" of the FDD Guidelines and instructions, but they create new substantive disclosures and disclosure prohibitions, and that any state that seeks to adopt these policies must follow its own state's legislative and regulatory laws, rules, and procedures to review and, if deemed appropriate, implement these proposed changes.

B. Discussion.

1. Lathrop GPM Supports Useful and Robust Franchise Disclosure.

Lathrop GPM wholeheartedly endorses and supports the state laws and regulations that require pre-sale disclosures for prospective franchisees. We agree with the intent of the laws, an example of which appears in California's Franchise Investment Law ("CFIL")² that states "It is the intent of this law to provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered." Another purpose of these

¹ In addition, we recommend and request that the Project Group provide a detailed record of the data, information, and reports it relied upon in developing the Proposal, including transcripts or summaries of calls and meetings it, or its members had, with individual franchisors, franchisees, lawyers, and members of the Project Group's advisory committee. In our view, more transparency is essential given the complexity and importance of the issues addressed in the Proposal.

² Cal. Corp. Code, Sec. 31001. *See also* Haw. Rev. Stat Sec. 482E-1(b); Ill. Stat. Ch. 815 Sec. 705/2; MD Bus. Reg. Code Sec. 14-202(b); NY Gen. Bus L. Sec. 680(2).

disclosure laws is “to **protect the franchisor and franchisee** by providing a better understanding of the relationship between the franchisor and franchisee with regard to their business relationship.” (emphasis added).³ The FDD as currently constructed, and if prepared by franchisors in compliance with the FTC Rule and NASAA’s FDD Guidelines,⁴ provides prospective franchisees with much of the information they need to make an informed decision. The FDD is one of the most valuable tools available to a prospective franchisee for evaluating a potential franchise business relationship, and to compare brands and offerings.⁵

The FDD is valuable for franchisors as well. A franchisor that prepares an FDD in compliance with the FTC Rule and NASAA’s FDD Guidelines understands that it has complied with the statutory and regulatory requirements that lawmakers and regulators have determined satisfies the intent of law. Franchisors expect that their compliance can, and should, be used as a defense against frivolous lawsuits and claims. Further, by evaluating the franchise opportunity through the lens of a prospective franchisee, franchisors can further the goal of providing a better understanding of the franchise relationship for both the franchisor and the franchisee.

Another benefit of fulsome disclosure is that the FDD may—and in fact does—deter some franchise sales. The information in an FDD, whether information about the franchisor, the costs, fees, and expenses that might be incurred, the financial performance of franchised outlets, or what the franchisor expects of the franchisee in terms of qualifications, training, due diligence, and operations—may convince a prospective franchisee not to purchase a franchise. That benefits both the franchisor and the prospective franchisee and is a goal of franchise disclosure. Therefore, the more information that can be provided—even if it is not flattering to the franchisor, or if it requires a prospective franchisee to conduct more thorough diligence on the franchise opportunity than he/she expected—the greater the likelihood that a prospective franchisee can make a better franchise purchase decision.

Lastly, robust disclosure benefits the franchise industry. Franchisees don’t wish to make “bad” investment decisions. Franchisors do not wish to make “bad” decisions in granting a franchise only to be in a long-term relationship with a franchisee that is (or may be) a poor performer or has entered into the relationship not fully informed of the risks and operational aspects of the business. Contrary to what appears to be a misperception on the part of the franchise

³ Cal. Corp. Code, Sec. 31001.

⁴ N. AM. SEC. ADM’R ASS’N, 2008 FRANCHISE REGISTRATION AND DISCLOSURE GUIDELINES 1 (2008), <https://www.nasaa.org/wp-content/uploads/2011/08/6-2008UFOC.pdf>.

⁵ We recognize, and we believe and expect that the Project Group recognizes as well, that the FDD is not, and should not be, the sole source for the appropriate and necessary diligence by a prospective franchisee. A franchisee should conduct research on the industry it is considering and the proposed geographic market, and should speak with existing and former franchisees. The FDD provides valuable information to guide a prospective franchisee in conducting this necessary diligence.

regulators, and what we have seen from comments by franchisee advocates, franchisors do not desire to sell franchisees with incomplete, misleading, or fraudulent information, only to have an operator ill prepared for the investment, and subject to default or termination. Franchisors do not wish to terminate franchises, and then have to close or resell the store, outlet, market, or territory. Franchisors incur significant and substantial costs in selling franchises, including advertising and promotion, legal costs, site selection assistance, training, and pre-opening assistance. Most franchisors barely break even on the initial franchise fee by the time the franchisee opens. A franchisor desires a strong and financially solvent operator over the long term, and one that understands the risks of business ownership, and is prepared for the sometimes rough waves of navigating business ownership. “Churning” is bad business. Therefore, any disclosures that may stop the formation of an unsuccessful franchise relationship are valuable to all parties and the franchise industry.

2. We Do Not Challenge Statutory Prohibitions On “Waivers”.

In making these comments on the Proposal, Lathrop GPM does not challenge state “anti-waiver” provisions, such as those that state that a “franchisor may not require a prospective franchisee to agree to a release, assignment, novation, waiver, or estoppel that would relieve a person from liability” under the law.⁶ Franchisors know, or they should know, that they cannot violate the franchise laws—for example, by attempting to sign a franchise agreement without providing an FDD at least 14 days in advance, or by making a false statement or a misrepresentation—and then require that a franchisee release the franchisor from liability or require a waiver, as a condition of granting the franchise. Such a release or waiver would undermine the purpose of the statutes, and the benefits of disclosure.

As we explain below, however, Questionnaires and Acknowledgments are not releases, waivers, or disclaimers. The Proposal’s attempt to equate Questionnaires and Acknowledgments with waivers and disclaimers is not factually or legally accurate. Questionnaires and Acknowledgments and the responses thereto are factual statements that are relied upon by franchisors as part of the franchise sale process; they benefit both franchisees and franchisors. They do not, and should not be construed to, violate state anti-waiver provisions.

3. Questionnaires and Acknowledgments Are Not Disclaimers, Waivers or Releases.

As an initial matter, Questionnaires and Acknowledgments do not fall within the plain meaning of the terms “disclaimer,” “release,” or “waiver.” A “disclaimer”⁷ as defined by Merriam-Webster is a “denial or repudiation of [a] legal claim.” *Black’s Law Dictionary* defines

⁶ MD Bus. Reg. Code Sec. 14-226. *See Also* Cal. Corp. Code, Sec. 31512; Ill. Comp. Stat. Sec. 705/41; Minn. Stat. Sec. 80C.21; NY Gen. Bus. L. Sec. 687 (4) and (5).

⁷ DISCLAIMER, Merriam-Webster.com., <https://www.merriam-webster.com/dictionary/disclaimer> (last visited Jan. 5, 2022).

“disclaimer”⁸ as a “renunciation of one’s legal right or claim.” Most Acknowledgements and Questionnaires, and the responses to them, are not disclaimers. They do not repudiate, renounce, or deny a claim. They are simply factual statements regarding what did or did not occur during the franchise sales process, or that document the prospective franchisee’s knowledge of certain facts contemporaneous with the signing of the franchise agreement.

Questionnaires and Acknowledgments also not waivers or releases. *Black’s Law Dictionary* defines “waiver”⁹ as the “voluntary relinquishment or abandonment — express or implied — of a legal right or advantage.” Similarly, *Black’s Law Dictionary* defines “release”¹⁰ as the “liberation from an obligation, duty, or demand; the act of giving up a right or claim to the person against whom it could have been enforced.” The responses to Questionnaires and Acknowledgments are factual statements that do not waive any claims, nor do they release or relinquish any rights otherwise enjoyed by a franchisee.

Even if Questionnaires and Acknowledgments are considered or treated as implicit disclaimers (and they are not), that does not mean that they are inappropriate. There are other admonitions and disclaimers in the FDD that are included for the franchisee’s benefit. For example, Item 19 of the FDD permits statements to put a franchisee on notice of certain facts, including what is included and what might be excluded from a financial performance representation. Item 13 may include certain factual statements intended to put a franchisee on notice of its rights respecting trademark use, or limitations on those rights. If these are appropriate admonitions, factual statements or “disclaimers” designed to put the prospective franchisee on notice of what to expect or not expect, the statements in Questionnaires and Acknowledgments that the Proposal seeks to ban are equally or more beneficial to the prospective franchisee.

Finally, acknowledgments, representations, and statements of fact are common provisions in all sorts of commercial contracts, from the smallest buy-sell agreements to purchase agreements and merger agreements with transactions valued at hundreds of millions to multiple billions of dollars, including franchise agreements, and including agreements in which a franchisee is selling his/her business and franchise to a third party. They are ubiquitous and beneficial to both parties.

⁸ DISCLAIMER, *Black’s Law Dictionary* (11th ed. 2019).

⁹ WAIVER, *Black’s Law Dictionary* (11th ed. 2019).

¹⁰ RELEASE, *Black’s Law Dictionary* (11th ed. 2019).

4. Questionnaires and Acknowledgments are Beneficial.
 - a. Acknowledgements and Questionnaires are Used to Identify Problematic Franchise Sales Practices and Are Used to Identify Prospective Franchisees That May Not Understand the Franchise Offer or the Documents.

Most franchisors are honest and scrupulous; they want to comply with both the language and the spirit of the laws and regulations. Franchisors desire a smooth and efficient—and legal—franchise sales process. Acknowledgements and Questionnaires are one tool that is used to ensure compliance with these objectives.

Many franchisor personnel have an IFA Certified Franchise Executive (“CFE”) designation which reflects successful attendance at IFA and other industry classes and educational programs, including successful completion of IFA’s “FranGuard”[®] Program, which is a 6-hour franchise law and sales compliance class. Many franchisors conduct periodic in-house franchise law and sales compliance training programs and have periodic updates and training sessions. We regularly conduct franchise law and sales compliance programs for our franchisor clients and various members of their staff, from CEOs to franchise development personnel to administrative staff who meet with and interact with prospective franchisees. We also have provided franchise compliance programs to area representatives of franchisors and third-party franchisee sales brokers hired by franchisors. In our experience, franchisors want everyone involved in the sales process to know and understand the rules, and to follow those rules scrupulously. Why? Because they want to offer and sell franchises properly and legally, and they want to avoid potential legal claims.

Acknowledgements and Questionnaires are not the principal element of a franchise sales compliance program. They can be, however, an extremely valuable “last line of defense” to prevent an improper franchise sale that might otherwise go undetected before it is too late.

Questionnaires and Acknowledgments can be used to identify problematic franchise sales practices. In our experience, when a franchisor sees a problematic answer in a questionnaire — such as an answer or statement that the franchisee received financial information outside of the FDD — the franchisor stops the sales process immediately and investigates the circumstances. In some cases, if there truly was an unauthorized financial performance representation, the sale will not go through. In other cases, the franchisor and franchisee may learn that the franchisee was mistaken¹¹, or that the information was not provided by the franchisor or its representatives (and may have come from industry sources, the internet, media, or franchisees in the system). The

¹¹ In an example provided by one of our clients, after reporting that he received assurances of certain revenues or profits outside of the FDD, the franchisee pointed to Item 19, and not outside sources. Consequently, the franchisor and prospective franchisee had discussions to clarify the misunderstanding, and the prospective franchisee was provided with additional opportunities to evaluate the franchise and the FDD’s FPR.

Project Group has acknowledged that statements in Questionnaires and Acknowledgments “can be useful to help franchisors root out dishonest sales personnel and avoid sales secured by fraud.” We wholeheartedly agree!

Contrary to the Proposal, Questionnaires and Acknowledgments do not shift the compliance burden from franchisors to franchisees, and they further the goals of the franchise sales laws, by confirming or highlighting issues that the franchisee should have understood and learned during the franchise evaluation process. Ultimately, franchisors still have the burden, and Questionnaires and Acknowledgments are just among the mechanisms that they use to satisfy their legal obligations. Further, Questionnaires and Acknowledgments are not documents in which franchisees provide legal conclusions as to the franchisor’s compliance or lack of compliance with governing laws. They are simply statements of fact.

b. Acknowledgements and Questionnaires Can Provide Material Disclosures Not Otherwise Identified, or Permitted to be Identified, in the FDD.

Questionnaires and Acknowledgments may also be used to document certain important facts, where other documentary evidence may not be available. There are still a few states that have retained the “first personal meeting” rule under their franchise laws (Iowa and New York¹²), requiring the delivery of the FDD at the earlier of the first personal meeting or 14 calendar days (in Iowa), or 10 business days (in New York) before the franchisee signs a contract or pays consideration. Some Questionnaires and Acknowledgments ask the prospective franchisee to indicate when that first personal meeting occurred, or confirm that the FDD was received prior to that first personal meeting. This avoids disputes and misunderstandings in the future. In addition, this is another check on the franchise sales process.

Another use for Questionnaires and Acknowledgments is to comply with FDD disclosure rules (under the FTC Rule and NASAA’s FDD Guidelines) to identify the “franchise sellers” involved in the sales process. While the Item 23 Receipt is supposed to include the names of the franchise sellers and potential franchise sellers, the FDD is provided early in the sales process and the Receipt is signed and returned to the franchisor. How can the prospective franchisee identify other individuals who may be “franchise sellers” whom they meet with or interact with later in the process, after they have returned the FDD Receipt? Questionnaires often include a question asking the franchisee to fill in the names of franchise sellers with whom they have interacted. This process is explicitly recognized as permitted in the FTC’s Franchise Rule Compliance Guide¹³ and benefits FTC and state enforcement activities.

¹² IA Code Sec. 551A.4 and NY Gen. Bus. L. Sec. 683.

¹³ *FTC Franchise Rule Compliance Guide* (2008) 117-119,

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

Questionnaires and Acknowledgments also are used to highlight items in the FDD and provisions in franchise agreements that may be material to a prospective franchisee yet are not required to be disclosed in the FDD. For example, many franchise agreements include provisions such as a mutual waiver of jury trial, a mutual waiver of punitive damages, and/or a contractual statute of limitations period. All of these provisions are permitted in commercial contracts, including franchise agreements. But these provisions are not specifically identified in Item 17 of the FDD, nor as a dispute resolution “risk factor.” Yet, it clearly is desirable for a prospective franchisee to be aware of these provisions. Many state franchise examiners have refused to register franchise offerings if a simple note calling out these provisions is included in Item 17. So, some Questionnaires and Acknowledgments include this valuable information.¹⁴

c. Questionnaires and Acknowledgments are Valuable to Determine if the Franchisee is Qualified for the Franchise and Has Done Its Due Diligence.

As discussed above, franchisors undertake significant efforts to offer and sell franchises to qualified franchisees. Franchisors do their due diligence and try to evaluate a prospective franchisee’s financial wherewithal, business acumen, and his/her communications, management, leadership, and interpersonal skills. Franchisors encourage franchisees to conduct thorough diligence regarding their brand, as well as other brands in the same industry, other non-franchise brands in the same industry, and business operations, finance, and management of running a business. As part of this process, franchisors encourage prospective franchisees to speak with existing franchisees and to consult lawyers, accountants, and advisors. They do this even though the FDD includes certain required recommendations and admonitions to this effect. Some franchisors provide a discounted initial franchise fee if the prospective franchisee retains a lawyer, or a lawyer with expertise in franchise law. Some franchisors will not grant a franchisee unless the prospective franchisee has spoken to a specified minimum number of existing franchisees (which is one of the purposes of the FDD list of franchisees). In sum, franchisors want to be sure that the franchisees are prepared to take on the challenges of business ownership.

¹⁴ In the case of *MaggieMoo’s G&R Moojestic Treats, Inc. v. Maggiemoo’s International, LLC*, 2005 WL 8174561 (D. Md. 2005), the franchisee claimed that it was unaware of the jury trial waiver. The court found that the FDD failed to highlight this provision, and specifically noted that neither Item 17 nor the risk factor page identified this provision. If a franchisee should be put on notice of these provisions, separate and apart from their appearance in the franchise agreement, yet the state franchise regulators will not permit a franchisor to include that notice as part of the risk factors or in Item 17, a Questionnaire or Acknowledgement is the only place to do so. Similarly, because arbitration clauses are sometimes challenged or criticized as “unconscionable” because they are allegedly buried in the “fine print” of a lengthy agreement, franchisors are able to highlight them for the franchisee in Questionnaires and Acknowledgments.

Many of the questions and statements in Questionnaires and Acknowledgments are intended to elicit information so that a franchisor can feel confident that the franchisee is ready to become a franchisee. If the franchisee is not ready, if the franchisee has not sought the advice of counsel, if the franchisee has not spoken with existing franchisees, or if the franchisee does not fully understand the risk of business ownership, the legal documents, or the legal and business aspects of the franchisor's brand, the franchisor will not grant franchise. This diligence on the part of the franchisor is a good thing – for the franchisor and the prospective franchisee.

Questionnaires and Acknowledgments are necessary, therefore, to elicit the relevant information. Reducing or eliminating the franchisee's ability to obtain necessary information will be harmful to franchisors, franchisees, and the industry as a whole.

Further, by putting Questionnaires or Acknowledgments in the FDD, a prospective franchisee is apprised of these conditions at a very early stage in the franchise sales process. These conditions are not sprung on a prospective franchisee at the last minute.

5. Franchise Cases and Jurisprudence Do Not Justify the Proposal's Elimination of, or Restrictions on, Questionnaires and Acknowledgments.

As discussed above, Questionnaires and Acknowledgments provide many benefits for franchisees and franchisors, and as discussed in Part II.B.9 below, we address each of the prohibited statements and explain why they are valuable. But preliminarily, we respectfully wish to highlight a fundamental flaw in the Proposal: no state franchise law prohibits franchisors from using disclaimers, acknowledgments, non-reliance clauses and questionnaires, and none of the court opinions cited in the Proposal states or holds that the statements in Questionnaires and Acknowledgments are unlawful or violate any of the state "anti-waiver" laws. To be sure, there are a few cases that criticize the use of Acknowledgements and Questionnaires, or are critical of specific situations in which they were used. In some of these cases, courts have refused to rely upon them to dismiss franchise law claims if they are deemed to be waivers. However, courts generally do allow the statements to be used as evidence at trials. Proper analysis requires a closer look at those situations, and a recognition of the nuances in the practices, the laws, and the courts' interpretation of the laws and the relevant factual scenarios.

For example, neither the *Randall*¹⁵ court cited by the Project Group, nor the other cases cited, holds that the relevant language in Questionnaires and Acknowledgments "violates state anti-waiver laws." Those cases also do not stand for the proposition that Questionnaires and Acknowledgments cannot be considered as evidence of reliance, or reasonable reliance, at either the summary judgment or trial stages. Rather, in the words of the *Hanley* opinion: "...[T]he integration clause and the disclaimers contained in the Franchise Agreement and the FDD are

¹⁵ *Randall v. Lady of Am. Franchise Corp.*, 532 F. Supp. 2d 1071, 1089 (D. Minn. 2007).

legally inoperative to bar plaintiffs' Maryland Franchise law claims to the extent that they would operate as a "release, ...waiver, or estoppel, B.R. Sec. 14-226 (a)(1)(ii) as to plaintiffs' claims of misrepresentations or omissions under B.R. Sec. 14-227 (a)(1)(ii)." But the Court did not hold that the integration clause and waivers were irrelevant. The court stated that "disclaimers might be persuasive to a fact finder with respect to the materiality of the alleged misrepresentation and omissions and the reasonableness of the plaintiff's reliance on them."

Further, some of the cases that the Project Group relies upon for the proposition that Questionnaires and Acknowledgments "violate" state anti-waiver provisions,¹⁶ do not support that position. For example, in the *Cornaud* case, the court dismissed common law fraud and misrepresentation claims because of disclaimers, but refused to dismiss a fraud claim under the New York Franchise Sales Act ("NYFSA"). This demonstrates three things. First, there is a distinction between common law fraud claims and state franchise law fraud claims. Here, the Court recognized that the statement made by the franchisee could be evidence to defeat the common law fraud claim, but not the state franchise law claim. Second the Court did not rule that the use of Questionnaires and Acknowledgments violated state law. Rather, the Court reviewed and analyzed the statements, and came to the conclusion that they could not be used to defeat a state law claim because to do so would improperly treat them as a waiver. The third lesson is that courts are quite capable of evaluating the Statements, the veracity of the parties, the value of the Statements, and whether they can or cannot be used to evaluate evidence of fraud. (We discuss this in greater detail, and provide additional caselaw support, below.) Courts are the correct and appropriate parties in our judicial, legislative and regulatory regimes to make these decisions.

In the *Hanley* case cited in the Proposal, the Court refused to use the disclaimers and acknowledgements as a basis for dismissing franchise law fraud claims under the Maryland franchise law. But the Court noted that these statements could be evidence on the issue of reliance at a later stage of the proceeding. Unfortunately, the case was settled following this decision, and therefore the Court did not have the opportunity to determine the issue on a full record. The Court in the *Randall* also refused to allow the disclaimers to be used as a basis for dismissing Minnesota franchise law claims, but did dismiss the Florida franchise law claims based upon the same language. The *Randall* court did not say that the disclaimers were unlawful, and was able to evaluate them considering specific claims under different state laws. Finally, the *Governarra* Court upheld the dismissal of NYFSA claims because of the disclaimers and acknowledgments.

Despite the broad claims in the Proposal, it is important to note the paucity of cases from the states that have franchise disclosure laws. The Proposal cites two decisions interpreting New York law (which came to inconsistent results), one interpreting Maryland law, and one interpreting Minnesota law. Although several Quizno's class actions are cited for the proposition that use of

¹⁶ *Coraud LLC v. Kidville Franchise Co., LLC*, 109 F. Supp. 3d 615, (S.D.N.Y. 2015); *Hanley v. Doctors Express Franchising, LLC*, No. 12-cv-794, 2013 WL 690521 (D. Md. Feb. 25, 2013); *Randall*, 532 F. Supp. 2d 1071; *Governara v. 7 Eleven, Inc.*, No. 13-cv-6094, 2014 WL 4476534 (S.D.N.Y. Aug. 20, 2014).

disclaimers is widespread, the holdings – precluding dismissal of claims because of the disclaimers — are not cited. Those cases were decided under Pennsylvania, Illinois and Wisconsin laws. Although franchise registration and disclosure laws also exist in California, Hawaii, Indiana, Michigan, North Dakota, Rhode Island, South Dakota, Virginia and Washington, no cases from those jurisdictions are cited. It does not appear that there is any extensive jurisprudence that supports banning or restricting Questionnaires and Acknowledgements.

6. Courts are Skilled at Evaluating the Evidence Provided by Questionnaires and Acknowledgments.

The Proposal asserts that “Questionnaires and Acknowledgements are not the most effective mechanisms for preventing fraud.” Proposal at 2-3 (citations omitted). Of course, even assuming *arguendo* that Questionnaires and Acknowledgements are “not *the* most effective mechanism for preventing fraud” does not mean that they are ineffective. There is no reason to eliminate an effective anti-fraud mechanism, whether or not it is the single most effective one. Moreover, as the Proposal concedes, Acknowledgements and Questionnaires “can be useful to help franchisors root out dishonest sales personnel and avoid sales secured by fraud.” *Id.* at 3. In view of this recognized benefit, a rule limiting or precluding the use of Questionnaires and Acknowledgments should require some compelling benefit, which in our view is not established.

We recognize that when faced with a claim of fraud or misrepresentation (whether as a violation of a state franchise law, or as a claim under common law or a non-franchise law), franchisors may seek to utilize statements made in Questionnaire or Acknowledgment to disprove the allegations, demonstrate a lack of reliance on the allegedly fraudulent statements, or possibly to question the credibility of the franchisee (particularly if the franchisee’s position on the facts has changed). However, using the Questionnaire or Acknowledgment responses for one of these purposes is not a violation of law, but a legitimate exercise of a party’s right to present relevant evidence and to defend itself in court or other dispute resolution proceeding.

The Proposal appears to be premised on a contention that courts will necessarily give dispositive weight to the answers given by prospective franchisees to Questionnaires and Acknowledgements, and that they will be used to defeat otherwise-meritorious fraud claims. *Id.* at 3 (without evidence, characterizing Questionnaires and Acknowledgements as “powerful defense mechanisms” that are effective “regardless of what has occurred in the franchise sales process”). In fact, however, courts have taken a far more nuanced view, and made assessments based upon the particular facts and circumstances of the claim. This is proven by examination of cases not cited in the Proposal.

For example, in *Cousins Subs Sys., Inc. v. Better Subs Development, Inc.*, No. 09-c-0336, 2011 WL 4855541 (E.D. Wis. 2011), the court found that the franchisee, an attorney, could not rely for purposes of negligent misrepresentation and strict liability misrepresentation claims on

alleged statements that were contradicted by the “two UFOCs, two questionnaires, and three contracts” that he signed, “all of which contained express provisions denying his ability to rely on representations of financial data and other purported promises.” 2011 WL 4855541, at * 7. Nonetheless, the Court found that “exculpatory clauses are not enforceable when the fraud is carried out intentionally or recklessly” and therefore denied summary judgment on the claims for intentional fraud.

Similarly, in *Hockey Enterprises, Inc. v. Talafous*, Civ. No. 10-2943(DWF/JSM), 2012 WL 72979 (D. Minn. Jan. 10, 2012), the Court readily concluded that the franchisee’s negative responses to a questionnaire were relevant, but declined to afford them dispositive weight on summary judgment. The Court noted the franchisor’s contention that, had the franchisee responded affirmatively to some of the questions, the franchisor likely would have stopped the sales process. *Id.* at *8. But the Court in the end concluded that “a reasonable jury could conclude that [the franchisee’s] false answers to the Questionnaire did not in fact mislead [the franchisor], and thus, [the franchisee’s] claims are not barred.” *Id.*

The Court’s acknowledgement of the relevance of the franchisee’s responses to a questionnaire cannot be seriously debated. Under Rule 401 of the Federal Rules of Evidence, evidence is “relevant” if “(a) it has any tendency to make a fact more or less probable than it would be without the evidence, and (b) the fact is of consequence in determining the action.” Fed. R. Evid. 401. In our experience, unless the alleged misrepresentation is actually in the FDD, whether or not an alleged misrepresentation was actually made almost invariably is one of most important issues in a case. And a contemporaneous questionnaire response denying that such a misrepresentation was made is highly relevant and therefore presumptively admissible under Fed. R. Evid. 402. In our view, there is no proper basis for denying such relevant evidence to the factfinder, particularly when the cases demonstrate the ability to weigh all of the evidence properly.

Courts have been more likely to afford greater weight to Questionnaires and Acknowledgements when the countervailing evidence of fraud is insubstantial. For example, in *Yogo Factory Franchising, Inc. v. Ying*, Civ. No. 13-630 (JAP)(TJB), 2014 WL 1783146 (D.N.J. May 5, 2014), the Court found that the franchisee’s “general allegations of fraud do not comply with Rule 9(b),” which requires fraud claims to be stated with specificity. 2014 WL 1783146, at *7. The Court noted that the franchisees “have referenced that these material misrepresentations relate to the ‘financial performance of the franchises,’ but have not specified anywhere exactly what was materially misrepresented.” *Id.* The Court relied upon the questionnaires, in which the franchisees denied receiving any financial representations, as an additional basis for dismissing the fraud counterclaims. *Id.* at 8. From the opinion, it is clear that the Court was not rejecting a meritorious claim based upon the questionnaire, as the Proposal suggests, but using the answers to the questionnaire as an additional basis for rejecting an already fatally flawed claim.

Likewise, in *A Love of Food I, LLC v. Maoz Vegetarian USA, LLC*, 79 F. Supp. 3d 376, 405 (D.D.C. 2014), the Court granted summary judgment on a franchise fraud claim because it concluded that the plaintiff “has so clearly failed to present clear and convincing evidence that such a claim was made that no reasonable juror could conclude that the statement was made.” The Court also noted that “[t]his Court, too, questions whether reliance on any such earnings statement . . . in the face of unambiguous disclaimers and its own certification of nonreliance [in a questionnaire] could be reasonable. *Id.* Again, the Court did not decide that a meritorious fraud claim had been waived; it found that the claim itself lacked merit and that the questionnaire responses provided further evidence of that fact. There is no proper basis for NASAA to interfere with the adjudicatory process by denying such evidence to the factfinder.

As *Yogo Factory Franchising* and *A Love of Food* demonstrate, and contrary to the implicit assumption in the Proposal, assertions of fraud by failed franchisees are not invariably (or, in our experience, even usually) meritorious. There are numerous cases where courts have found that self-serving testimony by franchisees was not credible and that, in contrast, the testimony by franchisor representatives was credible and consistent with other evidence. For example, in *Baskin-Robbins, Inc. v. Taj California, Inc.*, No. CV-01-09971 (JWJx) (C.D. Cal. Oct. 6, 2003), the Court concluded after a trial on the merits that the franchisee’s “testimony lacked credibility and his accountant . . . was less than completely credible.” Slip op. at 3. In contrast, the franchisor’s witnesses “were all credible.” *Id.* Similarly, in *Dunkin’ Donuts, Inc. v. Martinez*, No. 01-3589-CIV-HUCK (S.D. Fla. Feb. 21, 2003), a federal district court held that the franchisees were willfully violating federal tax and immigration laws, and that their sworn testimony to the contrary was “not credible in light of the overwhelming documentary evidence” and that it was “facially incredible and inconsistent with common knowledge and reason.” Slip op. at 11. As these and other cases suggest, the Proposal’s implicit assumption that self-interested franchisee testimony in lawsuits is inherently more credible than contemporaneous responses to a questionnaire is both unsupported and false.

7. Questionnaires and Acknowledgments are not Contracts – but Item 22 is an Appropriate Place in the FDD for these Disclosures.

Under the FTC Rule and prior NASAA FDD Guidelines, Questionnaires and Acknowledgments are not “contracts,” and therefore are not appropriate for inclusion in Item 22 of the FDD. However, many franchisors have included them in Item 22 (or at least many of our franchisor clients have done so), because (a) franchisors want to provide material and relevant information to prospective franchisees, (b) the FTC Rule and many state laws permit or require franchisors to include material information even if not specifically required under one of the 23 FDD Items, and (c) Item 22 seems to be the most appropriate Item in which to do so. Also, state franchise administrators generally have accepted Questionnaires and Acknowledgments in Item 22. While technically not required, we support including Questionnaires and Acknowledgments in the FDD (as an exhibit to Item 22) for the reasons discussed earlier, most importantly, to provide

beneficial disclosure to prospective franchisees early in the franchise sales process, so that the prospective franchisees know what is expected of them at “closing.”

8. The Limitation of the “Effect” of Questionnaires and Acknowledgments Unfairly and Unlawfully Strips the Benefits and Utility of Questionnaires and Acknowledgments.

In Section II.C.3 of the Proposal, whatever value and benefits to the parties and the sales process that might otherwise be retained by having a Questionnaire or Acknowledgment is eviscerated by the required statement or disclaimer:

“No statement, questionnaire, or acknowledgment signed or agreed to by a franchisee in connection with the commencement of the franchise relationship shall have the effect of (i) waiving any claims under any applicable state franchise law, including fraud in the inducement, or (ii) disclaiming reliance on any statement made by any franchisor, franchise seller, or other person acting on behalf of the franchisor. This provision supersedes any other term of any document executed in connection with the franchise.”

This disclaimer essentially states that no person, particularly a franchisor, can rely on any statement made by a franchisee. It provides a license to a franchisee to misrepresent facts, and state anything, knowing that a franchisor cannot rely on it. Further, even if a franchisee is truthful at the time of signing the franchise agreement, the franchisee can change its story when a dispute arises.

In addition, for the reasons we have discussed above, Questionnaires and Acknowledgments have value beyond the franchise law anti-waiver provisions, and limiting their use, or a party’s ability to rely on the statements unfairly and unlawfully restricts a franchisor from submitting valid evidence for a court or arbitrator to evaluate related to claims outside of the state franchise law.

A few states (most notably Maryland) have required some franchisors to include a statement in the FDDs (in the Maryland specific addendum) that addresses some of the concepts in this required disclaimer. But the Proposal far exceeds the current Maryland request.¹⁷

¹⁷ Our experience has been that many franchisors object to the disclaimers required by Maryland and question the state’s legal right to insist on such a disclaimer, but will accept the condition in order to obtain registration.

While we strongly disagree with the Proposal's suggested disclaimer, and disagree with the stated reasons for the Proposal, if the Project Group moves forward with a revised Proposal, we recommend the following disclaimer:

“No statement, questionnaire, or acknowledgment signed or agreed to by a franchisee in connection with the commencement of the franchise relationship (collectively “Statement”) shall have the effect of waiving any claims under any applicable state franchise law, including such state’s franchise law’s “anti-fraud” provision; provided however that any such Statement may be entered into evidence in any dispute resolution proceeding, and the limitation on the effect of such Statement shall have no effect on any other laws, rights, or claims of any party. This provision supersedes any other term of any document executed in connection with the franchise.”

This proposed revision retains the Proposal's focus on state franchise law anti-waiver provisions and protections for franchisees, while preventing the disclaimer from impacting other laws and rights of the parties in the franchise relationship.

9. Specific Provisions.

As discussed above, we oppose any proposal that would eliminate or severely restrict the use of Questionnaires and Acknowledgments. For the reasons stated above, we believe that the Proposal is flawed and based on inaccurate assumptions, and that Questionnaires and Acknowledgments serve the legitimate interests of franchisees, franchisors, and the franchise sales process. Further, the formulation of the prohibition in Section II.C.2¹⁸ leaves the prohibitions and restrictions open to wide interpretation. Consequently, we oppose any proposal or instruction of prohibited statements that provides open-ended interpretations that can vary over time, vary from state to state, or vary by examiner with a state.¹⁹ It seems to us that if the Project Group issues a Proposal with any “Prohibited Statements” it should be crystal clear as to what is prohibited and limit it to those statements, and should also include a list of statements and concepts that are permitted. Should the Project Group proceed with a revised Proposal, the following are our comments and suggestions on the eleven specific “Prohibited Statements” identified in Part C.2 of the Proposal, including reasons for inclusion in a Questionnaire or Acknowledgment.

¹⁸ The introductory statement says, “Prohibited Statements in Questionnaires, Acknowledgments, and similar documents **include but are not limited to**, the following:” (emphasis added).

¹⁹ Unfortunately, our experience in submitting initial and renewal registration applications in registration states over the last 35 to 40 years suggests that there is little uniformity or consistency of application across the states, and often inconsistency within a state, depending on the examiner and other factors.

a. *“That the Prospective Franchisee has read or understands the FDD or any attachments thereto, including the franchise or other agreement.”*

Reason for Inclusion: Franchisors do not wish to grant franchises to individuals who have not read the FDD, agreements, and other relevant information. This is a simple and standard part of necessary diligence. Additionally, if a franchisee does not understand something, the time to stop the process and clear up misunderstandings or seek counsel and advice is before the franchise agreement is signed, and not years later. Eliminating this statement may allow a prospective franchisee to enter into a business relationship that he/she is not prepared for, and it prevents the franchisor from stopping the sale before it is too late. Given the importance of the FDD to the process – a point on which we believe there is universal agreement – it is unclear why the Project Group would want to do anything that might disincentivize careful review of the FDD by a prospective franchisee.

b. *“That the Prospective Franchisee understands or comprehends the risks associated with the purchase of the franchise.”*

Reason for Inclusion: Similar to point “a” above, this is a necessary diligence question that should be asked by both franchisees and franchisors. Unlike securities, franchised businesses are not passive investments, and they come with various risks, many of which relate to owning and operating a business. Franchisees should be aware of these risks, and they should confirm their awareness of these risks.

c. *“That the Prospective Franchisee is qualified or suited to own and operate the franchise.”*

Reason for Inclusion: Similar to points “a” and “b,” this is a statement that a prospective franchisee should make to indicate that he/she has the skills and resources to own and operate a franchised business. This, too, is part of basic due diligence for both franchisors and franchisees. While a franchisor will be doing its own diligence to assess the franchisee’s skills, this is the necessary other side of the coin with the franchisee’s perspective. Further, we can think of a multitude of examples of franchise systems for which specific qualifications may be a pre-requisite to franchise ownership. For example, a health care related franchise that will require a certain amount of experience in the field, licensing, or credentialing; a childcare franchise or a franchise whose customers are primarily children or teenagers, that wants to avoid owners who may have problematic criminal histories related to children, or desires to have certain experience working with children or in education; or an ice cream franchise that desires a hands-on, in-store owner that has experience managing a labor force made up primarily of teenagers. Any question or statement designed to elicit this information would appear to be prohibited.

d. *“That, in deciding to purchase the franchise, the Prospective franchisee has relied solely on the FDD and not on any other information, representations, or statements from other Persons or sources.”*

Reason for Inclusion: Lathrop GPM agrees that an acknowledgement that a franchisee is “solely” relying on the FDD is problematic. This is not because the statement constitutes a waiver (it does not), but rather because it is likely to be impractical, and in many cases inaccurate. As noted above, most franchisors encourage prospective franchisees to seek information from existing and former franchisees (which is one purpose of including the names and contact information of franchisees in the FDD), industry sources, and advisors. If this particular statement is banned in NASAA’s final policy, we strongly urge the Project Group to qualify this, and recognize that statements such as the following, or similar to the following, are permitted:

“That, in deciding to purchase the franchise, the Prospective Franchisee has relied on the FDD, as well as information and statements from industry sources, other Persons (not employed by or representing the Franchisor), which may include current and former franchisee of [Brand X], and other sources, including the Prospective Franchisee’s independent research.”

e. *“That neither Franchisor nor Franchise seller has made any representation, including any financial performance representation, outside of or different from the FDD and attachments thereto.”*

Reason for Inclusion: As discussed extensively above, these types of statements are vital to root out potential fraud and to strengthen a franchisor’s franchise sales and legal compliance program. From the perspective of all involved parties, it is critical to stop a franchise sale if an unauthorized FPR was provided. We do not understand why the Project Group, or any attorney or party that desires to protect a franchisee’s interest, would eliminate a statement that may prevent a franchisee from making an investment decision based on information that it should not have received. In the alternative, as the example in footnote 11 above suggests, this statement, and the franchisor’s intervention, may be used to correct a prospective franchisee’s misunderstanding of financial information that he/she received.

f. *“That the success or failure of the franchise is dependent solely or primarily on Franchisee.”*

Reason for Inclusion: Similar to our comment in point “d” above, we would not recommend using a statement that uses the word “solely.” However, a franchised business is owned, operated, and managed by a franchisee. The franchisee makes hiring and firing decisions, is responsible for training of its workers, negotiates lease terms, and has control over numerous aspects of the business. A franchised business is not a “plug-and-play” guaranty of success.

Consequently, a statement in which the prospective franchisee acknowledges that he/she is responsible for the success or failure of the business is appropriate, and should be taken at face value as accurate. Franchisees should be made aware of the franchisor's expectation that the success of the business will be largely dependent on the franchisee's efforts and skill long before they sign a franchise agreement; this type of acknowledgment simply confirms that understanding.

g. *"That the Franchisor bears no liability or responsibility for Franchisee's success or failure."*

Reason for Inclusion: Similar to point "f" above, this statement is one that we might not recommend using, because of its of "absolute" wording with the use of "no" or "none." It might not be practical or realistic. But statements or questions in which a franchisee acknowledges his/her responsibility for the success of the business should be permitted.

h. *"That reiterates or duplicates any representation or statement already made elsewhere in the FDD and attachments thereto."*

Reason for Inclusion: Questionnaires and Acknowledgments that reiterate or duplicate certain representations or statements already in the FDD or an agreement may be appropriate to provide full and adequate disclosure. First, FDDs almost invariably are lengthy, as they disclose information based on 70+ pages of requirements issued under the FTC Rule or NASAA's own FDD Guidelines. If something critical or material is pointed out again, so that it is not missed, it a benefit for franchisees. Second, the FDD is already replete with FTC Rule and NASAA sanctioned duplication. For example, the risk factors address items already in the FDD; Item 9 and Item 17 summarize (and with Item 17 sometimes verbatim) language in the franchise agreement; and other disclosures such as fees may appear in Item 5, 6, 7, 8, and/or 11. The Proposal provides no justification why certain duplication of statements or facts in the FDD is permitted or required, yet other duplication is prohibited. Third, as noted above in Part II.B.4.b and footnote 13, because courts have been critical of inadequate disclosure of some contractual provisions, Questionnaires and Acknowledgments may be the only remaining place to disclose them, if the FTC, NASAA, and state franchise regulators refuse to allow them in Item 17 or elsewhere in the FDD. In sum, there is no harm, and only benefits, to including material statements and disclosures, particularly before the franchisee signs the franchise agreement.

i. *"That the Prospective Franchisee has had the opportunity to or has/has not actually consulted with professional advisors or consultants or other franchisees."*

Reason for Inclusion: These types of statements are critical for franchisors to be assured that the prospective franchisee has sought out, and obtained counsel. The FDD cover page includes a recommendation and admonition to seek an advisor, such as a lawyer or an accountant. If this is a condition that a franchisor wishes to impose on a franchisee to make sure the franchisee has obtained counsel, this type of statement is the best, most efficient, and most effective method to

do that. As discussed above, franchisors want franchisees to do their due diligence, and are willing to commit to the long-term business. Further, as discussed in Part II.B.4.c above, a franchisor that offers a reduced initial franchise fee if the franchisee obtains franchise counsel has no other way to determine if the franchisee has complied with the condition.

j. *“That the Prospective Franchisee agrees or understands that the Franchisor is relying on the Questionnaire, Acknowledgments, or similar documents, including to ensure that the sale of the franchise was made in compliance with state and federal law or that no unauthorized, inaccurate, or misleading statements were made.”*

Reason for Inclusion: These sorts of statements are simply putting the franchisee on notice that the franchisor is relying on the franchisee’s answers. This is extremely common in commercial transactions, and is already prevalent in franchising. Many franchise applications include similar statements, and some franchise agreements make it a default if the answers to the application are later discovered to be false. These statements are similar, and not inappropriate. Further, appropriate statements or questions do not ask the franchisee to confirm the franchisor’s compliance with laws. Rather, they explain that the franchisor is trying to comply with the laws, and that it is relying on these statements to determine if it has complied.

k. *“That requires or suggests that the Prospective Franchisees must agree to any Questionnaires, Acknowledgments, or similar documents prohibited by this Statement of Policy or provide false answers as a condition to the purchase of the franchise.”*

Reason for Inclusion: Franchisors should not be prohibited from imposing any commercially reasonable requirement on a franchise sale. Franchisors require, among other things, that its franchisees have a certain net worth and liquid assets, have business references, have a certain credit score, not have a criminal record, not be on the government’s “Blocked Persons” or “Specially Designated Nationals” list, sign a guaranty, have certain other owners and/or spouses sign a guaranty, and be truthful in all pre-signing statements. This statement is a reasonable condition that essentially says that the franchisor will not grant the franchisee a franchise unless the franchisee has demonstrated that it understands the business, understands the risks, has done its diligence, has retained a lawyer, etc. We agree with the Project Group that it is appropriate to prohibit a statement purporting to require the franchisee to provide false statements as a condition purchasing the franchise.

As discussed above in Part II.B.7, the requirement that completing a Questionnaire or Acknowledgment is a condition of granting a franchise should be provided with the FDD, very early in the franchise process. If a prospective franchisee does not wish to answer these questions, it can choose to not proceed with this franchisor. If a franchisee objects to this condition, there are literally thousands of other franchise brands to consider. But the franchisor needs these to be sure – as best as it can – that it has chosen the right franchisee.

10. NASAA and State Regulators Do Not Have Authority to Change the Law.

The content of FDDs are based on very detailed and specific requirements under the FTC Rule and state franchise disclosure laws. The FTC Rule, the state franchise disclosure laws, and the regulations promulgated those state laws, often refer to each other's disclosure rules. They acknowledge the existence of the other, and in some cases, a state may rely on the interpretation or rule by the FTC. It is important to note that both the FTC Rule and state laws prescribe what should be in the FDD.

Section 436.6 (b) of the FTC Rule requires franchisors to: “Disclose all required information clearly, legibly, and concisely in a single document using plain English.” So long as a Questionnaire or Acknowledgment clarifies a required disclosure, it would seem to be required, not prohibited.

NASAA, in the Proposal, acknowledges that the FTC, as part of the FTC's decennial review of that FTC Rule, conducted a public workshop in 2019 and 2020 that explored issues related to Questionnaires and Acknowledgments. Before that, when preparing the 2007 Amended FTC Rule, the FTC considered arguments that “waivers and disclaimers” should be prohibited in franchise sales. After thorough analysis, the FTC decided only to prohibit disclaimers of information in FDDs. It rejected most of the arguments that are now incorporated in the Proposal.²⁰ Yet, even though the FTC has not taken any action to change its position, or “directly addressed” these issues, NASAA is taking it upon itself to craft policies, which may be treated as regulations or laws by the state agencies charged with regulating franchise disclosure, to modify the requirements of an FDD. NASAA has no authority to modify or amend the FTC Rule. Assuming that the 14 states that have laws that rely upon the NASAA FDD Guidelines adopt or implement some or all of the Proposal, the policies in the Proposal will have no legal effect on required disclosures in 36 states, the District of Columbia, and Puerto Rico.

For states that are members of NASAA, each state law prescribes the form and format of the FDD. Some state laws instruct their designated franchise regulator — often the Securities Commission — to promulgate rules for the FDD, and whether it may be to follow the FTC Rule²¹, a state-required or specified FDD or prospectus, or a requirement to follow the NASAA FDD Guidelines. As an example, California²² requires that the franchise disclosure document contain the material information “specified by rule of the commissioner, and such additional disclosures as the commissioner may require” (emphasis added). Section 31503 of the CFIL requires that all

²⁰ 72 Fed. Reg. 15533, 15533-36 (Mar. 20, 2007).

²¹ See, e.g., Ill. Stat. Ch. 815 Sec. 705/16.

²² CA Corp Code Sec. 31114.

rules of the Commissioner must be made, amended or rescinded in accordance with California administrative rules. Under California Administrative Code § 310.111, the FDD must be the form of “UFDD” as adopted by NASAA on June 22, 2007. The “recommendations” or “policy” or “interpretation” of the Proposal actually amend the content of the FDD. The Proposal specifically states what should be included in an FDD in Item 22 (the Questionnaires and Acknowledgments) and simultaneously prohibits certain material disclosures and statements. These changes—no matter the strength of the recommendation of the Project group — should not be implemented in California by franchise regulators reviewing FDDs filed with initial or renewal application, unless and until the State follows its own laws and regulations to effectuate an amendment of the franchise disclosure rules. Other states have similar administrative law rules, designed to permit public comment and submit evidence before unelected regulators—who are likely and often civic-minded public servants carrying out their duties—make legal and regulatory changes.²³ We recognize that the Project Group is comprised of state franchise and securities regulators who know their own state laws, rules and regulations, and our comments are not intended as instructions to those government regulators and administrators. We are, however, respectfully pointing out that the Proposal includes substantive changes in the disclosure rules (as well as changes that affect more than disclosure), which, in most if not all states, are likely to require detailed administrative procedures prior to adoption or implementation.

We did not have the opportunity to highlight every state franchise law and regulation that could be violated by a state’s adoption of the NASAA Proposal, if this Proposal is approved by the Project Group and implemented by franchise regulators. However, one example is Maryland’s Franchise Registration and Disclosure Law²⁴, which includes a specific requirement that will be likely be violated by the Proposal. Maryland Code Section 14-216 prescribes the content of the “prospectus” (which is the FDD). Section 14-216(c)(27) states that the prospectus should include “any other information that the franchisor wants to give.” In addition, subsection (c)(28) states that the prospectus must include “any other information that the Commissioner reasonably requires.” These subsections permit a franchisor to include additional information (without even qualifying it as “material”), but do not confer upon the Commissioner any authority to eliminate disclosures.

²³ It is important to note here that the FTC follows the Administrative Procedure Act when seeking to amend its regulations, including this FTC Rule. It issues notices of proposed rulemakings, requests public comments, conducts public hearings, issues preliminary comments, and invites further comments, before amending, or choosing not to amend, a rule or regulation. These notice and comment periods are considerably longer than the one 30-day comment period that NASAA and Project Group provided for in the Proposal. As noted above, the very short comment period occurred around the end of year holidays, and at a time when the ABA Forum on Franchising’s List Serve was inoperable (through no fault of NASAA).

²⁴ MD Bus. Reg. Code Sec. 14-201 through 14-233.

11. The Factual Bases and Assumptions that Underpin the Proposal are Faulty.

The Proposal also appears to be based on an assumption that there is widespread fraud and misrepresentation in connection with the franchise sales process, which in our view is both unsubstantiated and false.

The Proposal (p.3) states that “Questionnaires and Acknowledgments can allow unscrupulous franchisors to avoid the consequences of franchise fraud.” As discussed above and in the cases cited, unscrupulous franchisors are not escaping franchise fraud. But the statement raises a larger issue – how many franchisors are unscrupulous, and is this proposal to best way to address that? Based on our extensive involvement in the industry, we strongly believe that the “bad apples” in the close to 4000 franchise brands in the US are quite few, and this Proposal represents a serious overreaction that will cause a tremendous amount of collateral damage. Most franchisors do not engage in fraud, and do their best to root out bad individual actors when they find them.

We are not aware of any evidence of pervasive franchise fraud. While we have not seen any definitive study of franchise law cases, claims, and arbitrations that allege franchisor fraud and misrepresentation, as part of our preparation for our comments at the FTC’s November 2020 public hearing on the FTC Rule, we conducted a survey of Westlaw cases alleging deception in franchise offerings during 2017-2019. In addition, we recently surveyed the ABA Forum on Franchising’s 2021 Annual Developments book, also looking for reported cases alleging fraud. Based on our research, and even extrapolating to cover expected arbitrations that have not been reported (based on research regarding arbitrations), the number of reported cases that alleged fraud was quite small, particularly when recognizing that approximately 30,000 new franchise outlets opened in the last four years (including 2020).²⁵ With no definitive quantitative survey it is difficult to pinpoint an exact number of cases alleging fraud. But this suggests that fraud, and allegations of fraud in franchise sales, is less than what may be expected based on the statements in the Proposal.

As stated above, the goal of the state franchise disclosure laws, and the FTC Rule is to prevent unfair and deceptive practices in the sale of franchises. It is not, and cannot be, to make sure that everyone investing in a franchise is successful in their business investment, or that franchisors should be responsible for franchisee’s lack of business success. Nor is it to penalize franchisors if prospective franchisees don’t assume responsibility for reading the disclosures which franchisors provide to them.

²⁵ *FRANdata 2021 Economic Outlook for Franchising* (2021), available to download at <https://www.frandata.com/2021-economic-outlook-for-franchising/?return=7134&source=2021%20Economic%20Outlook%20for%20Franchising> (last visited Jan. 4, 2022).

A secondary goal of the state laws and FTC Rule is to provide prospective franchisees with the material information they need to know to make reasonable investment decisions when considering acquiring a franchise. Although we have not found research that directly evaluates how well the state disclosure laws and the FTC Rule have fulfilled this goal, we have found recent research which shows that prospective franchisees—those who request and receive information about a franchise from a franchisor—decide NOT to pursue a franchise investment 98-99% of the time. According to FranConnect’s 2020 Franchise Sales Index Report, at page 5, “Sales closing effectiveness rates came in at 1.02% (a slight decrease from 2019’s average lead-to deal ratio of 1.14%).” FranConnect’s 2021 edition of the Franchise Sales Index Report indicates a similar closing rate in 2020 of approximately 1%.²⁶

We do not know exactly how FDDs affect these prospective franchisees’ decisions to back away from a franchise investment, but it is certainly plausible that the information which they read has persuaded them that franchising is too complicated, or that the franchises that they were considering are not appropriate for them, or both.

It is fair to conclude that the current state laws, and the FTC Rule, in their present forms, and the FDDs as currently written, are performing as they should, and that Questionnaires and Acknowledgements play a role in helping franchisees in their decision process.

12. The Public Should Have Access to the Project Group’s Research.

As is evident from our comments, and likely the number of comments received by others in the franchising industry, the Proposal represents a significant policy change, with significant implications. Yet, other than a mere five pages of discussion, franchisors, franchisees, lawyers, judges, and the general public have no insight into the deliberations of NASAA or the Project Group. We know from our experience in franchising that the Project Group speaks with many industry advisors, and even has its own “industry advisory group.” Therefore, Lathrop GPM requests that NASAA and the Project Group make publicly available the data reviewed, and statements relied upon, by the Project Group, including meeting minutes or summaries of discussions with other regulators, industry professionals, and the Project Group’s industry advisory committee. Given the regulatory or quasi-regulatory nature of the Project Group’s work, greater transparency is essential.

²⁶ *The FranConnect Franchise Sales Index Report 2020*, <http://go.franconnect.com/hubfs/FranConnect%20Franchise%20Sales%20Index%202020.pdf> (last visited Jan. 4, 2022); *The FranConnect Franchise Sales Index Report 2021*, https://go.franconnect.com/hubfs/FC_franchise.sales.index.2021.pdf (last visited Jan. 4, 2022).

13. Prospect of a System of Dual FDDs.

Adoption of the Proposal will likely result in franchisors moving to two forms of FDD – one for the states that require franchise registration and another for the remaining states. As set out above, no court or regulatory body has previously prohibited use of franchise questionnaires, and franchisors have found them useful for identifying potential problems and misunderstandings at the outset of the franchise relationship rather than years later. Consequently, it is likely that franchisors will continue to use questionnaires wherever they are permitted, leading to the practice of using two forms of FDD rather than one. This will frustrate one of NASAA’s stated goals, namely “to achieve a more uniform approach to franchise disclosure” as stated in the Introduction to NASAA’s *Commentary on 2008 Franchise Registration and Disclosure Guidelines*, and will increase franchisors’ compliance costs.

III. Concluding Remarks

For all of the reasons that we have discussed, Questionnaires and Acknowledgements serve a useful and important purpose in the franchise disclosure process, and their use should not be curtailed or eliminated as contemplated by the Proposal. Questionnaires and Acknowledgements can protect both the franchisor and prospective franchisees by ensuring compliance with disclosure requirements, as well as by alerting franchisors to any potential issues, such as an improper earnings claim, prior to entry of a franchise agreement. This allows the issue to be resolved appropriately, before either party has made a substantial commitment to a long-term contractual relationship, and also facilitates prevention of any future violations. In our view, encouraging full and complete disclosures and prevention of violations should be the primary consideration in adopting new policies, not maximizing a franchisee’s leverage in the event of subsequent litigation. This focus on litigation posture, as opposed to ensuring fulsome disclosure, represents a fundamental flaw with the Proposal. Even with respect to litigation, however, the Proposal mischaracterizes the effects of Questionnaires and Acknowledgements. As reflected in the cases we cite, while courts have properly considered responses to Questionnaires and Acknowledgements as relevant evidence to determine material disputes facts, they generally have not been used to override otherwise well-substantiated claims. As such, in our view, the Proposal ignores (or, at a minimum, materially understates) the benefits of Questionnaires and Acknowledgments, and substantially overstates the purported harm associated with them. Accordingly, we hope that the Project Group will reverse any recommendation that would preclude or generally constrain franchisor use of appropriate Questionnaires and Acknowledgments. At a minimum, we would request that the Project Group consider our specific comments with respect to some of the language that the Project Group finds objectionable, and reform the Proposal on that basis.

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Once again, thank you for the opportunity to submit these comments. We sincerely hope that this information will be useful in your consideration of, and hopefully revisions to, the policy regarding Questionnaires and Acknowledgments set forth in the Proposal.

Respectfully submitted,

Lathrop GPM LLP Franchise Group

Eli Bensignor
Sandy Bodeau
Katie Bond
Samuel Butler
Elizabeth Dillon
John Fitzgerald
Maisa Frank
Michael Gray

Cameron Johnson
Mark Kirsch
Peter Klarfeld
Gaylen Knack
Craig Miller
Marilyn Nathanson
Ryan Palmer
Justin Sallis

Frank Sciremammano
Michael Sturm
Erica Tokar
James Wahl
Eric Yaffe
Robert Zisk
Carl Zwisler