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W-13: THE 2022 NASAA STATEMENT OF POLICY AND OTHER REGULATORY DEVELOPMENTS

Mark A. Kirsch
Lathrop GPM, LLP
Washington, D.C.

Dale Cantone, Esq.
Office of the Attorney General,
Securities Division
Baltimore, MD

and

Theresa Leets, Esq.
Department of Financial Protection
& Innovation
Los Angeles, CA

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W-13: THE 2022 NASAA STATEMENT OF POLICY AND OTHER REGULATORY DEVELOPMENTS[1]

I. INTRODUCTION

As franchise law practitioners know, the offer and sale of franchises are subject to federal and state franchise investment laws, including the Federal Trade Commission's ("FTC") Franchise Rule (the "FTC Franchise Rule") and state franchise investment laws (also referred to as registration and disclosure laws) in 14 states[2]. We assume that the readers of this paper have a basic familiarity with the regulatory scheme.

This paper will address the North American Securities Administrators Association, Inc. ("NASAA")[3] Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments ("Statement of Policy" or "SOP"), including a summary of the SOP, comments for and against the SOP, and the possible impact of the SOP on franchise disclosure. While the SOP was a new development from NASAA in the past year, each year state franchise regulators will see new issues arise in Franchise Disclosure Documents filed with their agencies, or may continue to see filings with previously discussed problems or issues. This paper will also address some of these other registration and/or disclosure issues that are of particular concern to the state franchise regulators.

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1 The opinions expressed in this paper are not those of the California Department of Financial Protection, Maryland Attorney General's Office, NASAA or Lathrop GPM LLP.

2 16 CFR §436. The 14 states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, Virginia, Washington, and Wisconsin. They are sometimes referred to as "registration states" or "filing states." *See* CAL. CORP. CODE §§ 31000 through 31516; HAW. REV. STAT. § 482E-1 through § 482E-12; 815 ILL. COMP. STAT. §§ 705/1 through 705/44; IND. CODE §§ 23-2-2.5; MD. BUS. REG. CODE §§ 14-201 through 14-232; MICH. COMP. LAWS §§ 445.1501 through 445.1546; MINN. STAT. §§ 80C.01 through 30C.22; N.Y. GEN. BUS. LAW ART. 331 §§ 680, et seq.; N.D. CENT. CODE §§ 51-19-01 through 51-19-17; R.I. GEN. LAWS §§ 19-28.1-1 through 19-28.1-34; S.D. CODIFIED LAWS §§ 37-5B-1 through 37-5B-53; VA. CODE ANN. §§ 13.1-557 through 13.1-574; WASH. REV. CODE §§ 19.100.010 through 19.100.940; WIS. STAT. §§ 553.01 through 553.78. In addition, Oregon has a franchise disclosure law, The Oregon Franchise Transactions law, ORE. REV. STATUTES Title 50, Chapter 650, §§ 650.005 through 650.085. There is no registration or review process, and pursuant to the Oregon Administrative Rules, Division 325 – Franchises, a franchisor must deliver a disclosure document required by the FTC Franchise Rule (*see* § 441-325-0020).

3 NASAA is an organization that represents state and provincial securities regulators in the United States, Canada, or Mexico. According to the NASAA website, NASAA members have a multifaceted mission of protecting investors from fraud and abuse, conducting investor education, providing guidance and assistance via the established regulatory framework, and ultimately helping power the North American economy by ensuring the integrity of the financial markets. *See* WELCOME TO NASAA, https://www.nasaa.org/about/ (last visited Aug. 22, 2022). Because most state franchise administrators are also the state's securities regulators, NASAA's mission includes protecting franchise investors, and NASAA has established a standing project group to coordinate projects for franchising and business opportunity investments.

II. NASAA STATEMENT OF POLICY REGARDING THE USE OF FRANCHISE QUESTIONNAIRES AND ACKNOWLEDGEMENTS*

**This Section II reflects the viewpoints of only Mr. Cantone and Ms. Leets, and Mr. Kirsch does not wish to be deemed a co-author of this Section II.*

On September 18, 2022, NASAA[4] adopted the SOP.[5] At the same time, NASAA announced that the SOP would become effective starting January 1, 2023. A copy of the final SOP, as adopted by NASAA, is attached as Appendix 1.

A. Background

NASAA first signaled it was developing a potential policy on franchise questionnaires and acknowledgments in December 2021, with the release of a proposal for a Statement of Policy on Franchise Questionnaires and Acknowledgments ("Proposal" or "Proposed SOP"). The Proposed SOP was originally drafted by the NASAA Franchise and Business Opportunity Project Group ("Franchise Project Group"). Upon the release of the Proposed SOP, NASAA stated that the Proposal would seek to "address the problem of inappropriate uses of franchise questionnaires and acknowledgments in franchise offerings."[6]

B. Purpose of the Proposed SOP

The Proposed SOP states that it was prepared in order to "set standards for the proper use of questionnaires and acknowledgements in franchise offerings."[7] It refers to the fact that over at least the last 30 years, franchisors have included in their franchise agreements and FDDs language that they can later use as a disclaimer of liability. The Proposed SOP notes that "[f]ranchisors routinely seek to use Questionnaires, Acknowledgments (collectively Q&As), and other forms of contractually required disclaimers to insulate themselves from potential liability by franchisees alleging fraud and misrepresentations in the offer and sale of a franchise."[8] The Proposed SOP uses the term "Questionnaire" to refer to a document that some — but not all — franchisors require prospective franchisees, at or prior to signing a franchise agreement, to mark

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[4] NASAA is an organization that represents state and provincial securities regulators in the United States, Canada, or Mexico. According to the NASAA website, NASAA members have a multifaceted mission of protecting investors from fraud and abuse, conducting investor education, providing guidance and assistance via the established regulatory framework, and ultimately helping power the North American economy by ensuring the integrity of the financial markets. *See* WELCOME TO NASAA, https://www.nasaa.org/about/ (last visited Aug. 22, 2022). Because most state franchise administrators are also the state's securities regulators, NASAA's mission includes protecting franchise investors, and NASAA has established a standing project group to coordinate projects for franchising and business opportunity investments.

[5] N. AM. SEC. ADM'R ASS'N, NASAA STATEMENT OF POLICY REGARDING THE USE OF FRANCHISE QUESTIONNAIRES AND ACKNOWLEDGMENTS (Sept. 18, 2022), https://www.nasaa.org/wp-content/uploads/2022/09/NASAA-Franchise-Questionnaires-and-Acknowledgments-Statement-of-Policy-9-18-2022.pdf [hereinafter *Statement of Policy* or *SOP*].

[6] N. AM. SEC. ADM'R ASS'N, REQUEST FOR PUBLIC COMMENT: PROPOSED STATEMENT OF POLICY REGARDING THE USE OF FRANCHISE QUESTIONNAIRES AND ACKNOWLEDGEMENTS (Dec. 6, 2021), https://www.nasaa.org/wp-content/uploads/2021/12/Request-for-Public-Comment-SOP-on-Franchise-Questionnaires-12-6-2021.pdf [hereinafter *NASAA Proposed SOP*].

[7] NASAA Proposed SOP at 1.

[8] NASAA Proposed SOP at 2.

"yes" or "no" to a series of questions or agree to a series of representations about what purportedly occurred, or did not occur in the franchise sales process.[9] The Proposed SOP uses the term "Acknowledgments" to refer to a type of disclaimer that takes the form of a series of acknowledgments in the franchise agreement.[10]

The Proposed SOP suggests that the practical effect of Q&As is to act as "powerful defense mechanisms that franchisors can use to defeat claims of fraud and misrepresentation regardless of what has occurred in the franchise sales process. As a result, Q&As can allow unscrupulous franchisors to avoid the consequences of franchise fraud."[11] While acknowledging that Q&As can be useful to help franchisors "root out dishonest sales personnel and avoid sales secured by fraud," the Proposed SOP states that this result can be accomplished only "by shifting the compliance burden from franchisors to prospective franchisees."[12] The Proposed SOP asserts it is the franchisor's burden to police its own sales personnel and agents. Franchisees should not have to know and identify whether a violation of law has occurred during their sales process.

The Proposed SOP also describes the FTC's then-current position on franchise waivers and disclaimers, noting that, in 2007, the FTC promulgated the current amended FTC Franchise Rule that includes a limited ban on disclaimers in the FDD itself and its exhibits or attachments. When the FTC promulgated the FTC Franchise Rule, it did not specifically address a franchisor's use of Questionnaires or the effect of Acknowledgments on franchisee fraud claims. In 2019, the FTC announced it was soliciting public comments on the FTC Franchise Rule. One issue the FTC raised related to the impact the FTC Franchise Rule has had on the flow of truthful information and on the flow of deceptive information to prospective franchisees. Moreover, as of the date of issuance of the Proposed SOP, the FTC had not issued any statements on Q&As and had not indicated whether it intends to modify the current FTC Franchise Rule. As of the date of this paper (October 15, 2022), the FTC still has not indicated whether it intends to modify the current FTC Franchise Rule or take any other action regarding the use of questionnaires and acknowledgments in franchising.

The Proposed SOP recognizes that several states have enacted franchise registration and disclosure laws that include protections for prospective franchisees that are not found in the FTC Franchise Rule. These protections are modeled on securities anti-fraud laws that prohibit a person from making untrue statements of material fact or omitting to state a material fact regarding a franchise offering ("Anti-Fraud Provisions"). These laws also commonly include statutes that prohibit and render void any provision or condition requiring a prospective franchisee to agree to a release, waiver or estoppel that would relieve a person from liability under the law ("Anti-Waiver Provisions").[13]

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[9] NASAA Proposed SOP at 2.

[10] NASAA Proposed SOP at 1.

[11] NASAA Proposed SOP at 3.

[12] NASAA Proposed SOP at 3.

[13] See CAL. CORP. CODE §§ 31000 through 31516; HAW. REV. STAT. § 482E-1 through § 482E-12; 815 ILL. COMP. STAT. §§ 705/1 through 705/44; IND. CODE §§ 23-2-2.5; § 14-201 through 14-232; MICH. COMP. LAWS §§ 445.1501 through 445.1546; MINN. STAT. §§ 80C.01 through 80C.22; N.Y. GEN. BUS. LAW ART. 331 §§ 680 et seq.; N.D. CENT. CODE §§ 51-19-01 through 51-19-17; R.I. G. LAWS §§ 19-28.1-1 through 19-28.1-34; S.D. CODIFIED LAWS §§ 37-5B-1 through

Although not quoted in the Proposed SOP (or in the SOP), the following examples of specific state anti-waiver provisions, from Virginia, Maryland, and California, are illustrative:

> Virginia: "Any condition, stipulation or provision binding any person to waive compliance with any provision of this chapter or of any rule or order thereunder shall be void; provided, however, that nothing contained herein shall bar the right of a franchisor and franchisee to agree to binding arbitration of disputes consistent with the provisions of this chapter.[14]
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> Maryland: "As a condition of the sale of a franchise, 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 this subtitle."[15]
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> California: "Any condition, stipulation or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law or any rule or order hereunder is void."[16]

The Proposed SOP states that "[a]lthough not all courts agree, many courts have concluded that franchise contractual disclaimers, including Questionnaires and Acknowledgements, violate state Anti-Waiver Provisions,"[17] For example, in *Randall v. Lady of America*,[18] the court explained "[t]he disclaimer cannot change the historical facts; if the dishonest franchisor made misrepresentations, then he made misrepresentations, no matter what the franchise agreement says. Thus, the disclaimer can only be an attempt to change the legal effect of the misrepresentations. That is precisely what [the Minnesota] anti-waiver language forbids."[19]

The Proposed SOP states NASAA's position that Questionnaires and Acknowledgments violate state Anti-Waiver Provisions when they are used as contractual disclaimers that release or waive a franchisee's rights under a state franchise law. The Proposed SOP also recognizes that the "prospective franchisee who signs a Questionnaire or Acknowledgment, and later denies the accuracy of what was signed would have to explain such discrepancy, but they should have the opportunity before a factfinder, rather than have their claims dismissed based solely on having signed a Questionnaire or series of Acknowledgements."[20]

37-5B-53; VA. CODE ANN. §§ 13.1-557 through 13.1-574; WASH. REV. CODE §§ 19.100.010 through 19.100.940; WIS. STAT. §§ 553.01 through 553.78. For purposes of this paper, and following some NASAA policy statements, these 14 states are referred to as "registration states" or "Filing States."

[14] VA CODE ANN. §13.1-57(c).

[15] MD. BUS. REG. CODE §14-226. Also, this provision is cited in one of the cases cited in the SOP, Hanley v. Drs. Exp. Franchising, LLC, No. CIV.A. ELH-12-795, 2013 WL 690521, (D. Md. Feb. 25, 2013) which was also cited by some of the commenters in favor of the SOP, and cited and distinguished by several commenters opposed to the SOP.

[16] CA CORP. CODE § 31512.

[17] NASAA Proposed SOP at 4.

[18] Randall v. Lady of Am. Franchise Corp., 532 F. Supp. 2d 1071, 1088 (D. Minn. 2007).

[19] NASAA Proposed SOP at 4-5; MINN. STAT. 80C.21.

[20] NASAA Proposed SOP at 5.

The Proposed SOP observes that many Q&As currently found in some FFDs and franchise agreements are replete with questions and representations that serve no legitimate purpose. Other Q&As require a prospective franchisee to acknowledge or answer questions that are subjective, unreasonable or repeat disclosures that have already been disclosed in the FDD. Some Q&As require prospective franchisees to agree that they understand specific disclosures made in an FDD or the terms of the franchise relationship. These provisions are inconsistent with the legislative intent behind state franchise laws. The state franchise laws were enacted to protect prospective franchisees by requiring that franchisors provide presale disclosure. State franchise laws serve to protect franchisees from franchisors who commit fraud or make misleading material disclosures or omissions.

C. <u>Public Comment Period</u>

Along with the release of the Proposed SOP, the Franchise Project Group and NASAA requested public comments on the Proposal and that, after the close of the comment period, the Franchise Project Group would review the comments and consider whether to present the Statement of Policy, in its original or revised form, for a vote of the NASAA membership.[21] The public comment period on the Proposed SOP commenced on December 6, 2022 and ended on January 5, 2022. A total of 39 comments were submitted to NASAA.[22]

D. <u>Public Comments</u>

The comments to the Proposed SOP generally can be segregated as 25 in favor of, or in support of the SOP; 13 against the Proposed SOP; and 1 as neutral, non-committed, or including a variety of comments for and against. The authors of this Section wish to acknowledge that many of the comments were varied, and many had nuanced and detailed comments, and these are broad categorizations. (The list of commenters is attached as Appendix 2.)

While there are significant differences between the comments "for" and "against" the Proposed SOP, there were two areas in which there was common ground and agreement in support of certain aspects of the Proposed SOP. Specifically, the Proposed SOP states that if a franchisor requires a prospective franchisee to sign a Q&A or similar document prior to signing a franchise agreement, the proposed form must be attached to the FDD under Item 22.[23]

Most commenters – whether in the "for" or "against" camp – supported this position or did not strongly object to this position. In addition, the Proposed SOP provides that all FDDs must include a statement or legend that explains that a Q&A, or statements similar to a Q&A in a franchise agreement, should not have the effect of waiving claims under a state franchise law or violating an anti-waiver provision.[24] Although there was not unanimous support for the wording

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[21] *See* NASAA Proposed SOP.

[22] The comments are available at, *NASAA Proposals*, N. Am Sec. Adm'r. Ass'n, https://www.nasaa.org/nasaa-proposals/?t=franchise&y=2021 (last visited Aug. 22, 2022). References to the comments or individual commenters throughout this paper are referred to as "SOP Comments," and can be accessed with the foregoing URL. In addition, Appendix 2 to this paper includes the names of the individuals or entities that submitted comments.

[23] The Proposed SOP also imposes this requirement on video or electronic recording of a Q&A, and states that the written script must be included in Item 22.

[24] *See* exact text of legend found in Sec. II.G., at 9 *infra*.

of the legend stated in the Proposal, many commenters who were opposed the Proposed SOP, or opposed parts of the Proposed SOP, expressed some support for some type of legend in the FDD that explains this limitation on the use of Q&As.

There was widespread disagreement over the remaining aspects of the Proposed SOP. Many of the general statements in favor of the Proposed SOP confirmed the veracity of many of the arguments put forth in the SOP. Many comments shared experiences where franchisors provided unlawful financial performance information, “financial performance representations (also referred to as “FPRs”),” “earnings claims,” and similar information outside of the FDD’s Item 19, and then experienced franchisors using Q&As to insulate them from liability for omissions or misrepresentations. As noted above, there were 13 comments submitted opposing some or all of the SOP. Most of these comments in opposition to the Proposal were from law firms that represent primarily franchisors and franchisor interests.

Many of the commenters in the “opposition” camp agreed that deceptive and fraudulent franchise sales practices should not be permitted or tolerated in franchising (but disputed the breadth or scope of these practices). Many of the commenters that addressed one or more of individual 11 “Prohibited Statements” in the Proposed SOP also agreed that Q&A statements that used absolute terminology (such as “the Franchisor bears ‘no’ liability or responsibility for Franchisee’s success or failure,” or “The success or failure of the franchisee is dependent ‘solely’ or primarily on Franchisee” *(emphasis added)*) is not appropriate, and not realistic. Some commenters also specifically stated that franchisors should not require prospective franchisees to provide false answers as a condition to purchasing a franchise.

Despite agreeing with some parts of the Proposed SOP, the group of commenters that we have categorized as “opposed” raised a number of objections to the Proposed SOP. The reasons submitted in opposition to the Proposed SOP include that the Proposed SOP is too broad,[25] that Q&A are beneficial to root out and identify problematic franchise sales practice – as part of the process, not as the sole method to eliminate such practices,[26] that Q&As identify prospective franchisees who have not done sufficient diligence to buy a franchise and may not understand the risks and the details of the offer,[27] that Q&As provide material information and disclosures that are not otherwise identified in the FDD;[28] and that Q&As identify prospective franchisees who may

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[25] *See* for example, comments of DLA Piper and Lathrop GPM at SOP Comments.

[26] *See* for example, comments of DLA Piper, Greensfelder Hemker & Gale, Larkin Hoffman, Lathrop GPM, MSA Worldwide, and Plave Koch at SOP Comments.

[27] *See* for example, comments of Baker, Donelson, Bearman, Caldwell & Berkowitz, Davis Wright Tremaine, and Faegre, Drinker, Biddle & Reath, at SOP Comments.

[28] One example identified from one commenter was the issue of disclosing jury trial waivers which are not expressly part of the FDD disclosures. In the case of G&R Moojestic Treats, Inc. v. MaggieMoo's Int’l, LLC, No. WMN-04-1694, 2005 WL 8174561 (D. Md. Mar. 10, 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. It is not clear from the reported case if the court knew that the UFOC disclosure rules did not require such a disclosure, and that additional disclosures are often restricted by state franchise examiners. The SOP commenter stated that if a court ruling suggested that a franchisee should be put on notice of these provisions, separate and apart from their appearance in the franchise agreement, and the franchisor is not permitted to include that information as part of the risk factors or in Item 17, a Q&A is the appropriate, if not the only, place to do so. The commenter added, “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 Q&As.” *See* comments of Lathrop GPM at SOP Comments. The regulator authors of this paper disagree with this comment and point out that the purpose behind state pre-sale disclosure laws is to inform prospective

not understand the offer and the information and allow them the opportunity to better understand the contract terms and franchise relationship before signing the franchise agreement.

The comments "opposed" to the Proposed SOP are long, varied, and detailed, and a comprehensive summary of the comments is beyond the scope of this paper. For a link to the full text of all the public comments to the Proposed SOP see *supra* note 21. In general, however, the commenters that supported the Proposed SOP argue that Q&As act as a "waiver" of a franchisee's right under the franchise laws, and therefore, are a violation of those laws. In contrast, the commenters in opposition to the Proposed SOP argue Q&As act as a factual record that does not waive any rights and therefore do not violate the law.

E. <u>NASAA's Adoption of the SOP</u>

On September 22, 2022, NASAA announced that its members had formally adopted a Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments on September 18, 2022. The final SOP adopted by NASAA was not significantly modified from the original Proposed SOP. NASAA's announcement stated that the SOP would become effective on January 1, 2023.

F. <u>What the SOP Requires</u>

Section II of the SOP states that it applies to Questionnaires, Acknowledgments, and similar documents that appear in FDDs and applicable attachments and exhibits used in the offer and sale of franchises where an Anti-Waiver or Anti-Fraud Provision applies to the offer or sale. The SOP lists states with one or both of those provisions. In general, those states are the ones commonly known as the franchise registration states.[29]

The SOP includes a group of definitions from the NASAA 2008 Franchise Registration and Disclosure Guidelines, including "Franchise," "Franchise Seller," "Franchisor," "Person," and "Prospective franchisee."

Section II.B of the SOP requires that if a franchisor requires a prospective franchisee to verbally respond to Q&As or similar statements on video or other electronic media recording, a written script of the Q&A from that format must be attached to and included as part of the FDD, in Item 22.[30]

Section II.C.1, prohibits Q&As that are subjective or unreasonable, or would cause a reasonable prospective franchisee to surrender or believe that they have surrendered any rights to which they are entitled under federal or state law, or would have the effect of shifting a franchisor's disclosure duties under federal or state law to the Prospective franchisee, or that are otherwise a Prohibited Statement under the SOP. This language of the Section is similar to the

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franchisees through disclosure, not act as a "defense" document that provides an advantage in litigation or otherwise to franchisors.

[29] *See* footnote 2 *infra.*

[30] SOP Sec. II(B) at 6.

provision found in a NASAA Real Estate Investment Trust (REIT) Statement of Policy[31] that NASAA adopted more than 15 years before the present SOP.

Section II.C.2 of the SOP enumerates 11 Prohibited Statements in Q&As:

a. That the Prospective franchisee has read or understands the FDD or any attachments thereto, including the franchise or other agreement.

b. That the Prospective franchisee understands or comprehends the risks associated with the purchase of the franchise.

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

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.

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.

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

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

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

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

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.

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.

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31 *See* N. AM. SEC. ADM'R ASS'N , NASAA STATEMENT OF POLICY REGARDING REAL ESTATE INVESTMENT TRUSTS (adopted by the NASAA membership on May 7, 2007) Sec. III (D) (4) https://www.nasaa.org/wp-content/uploads/2011/07/g-REITS.pdf ("The SPONSOR and each PERSON selling SHARES on behalf of the SPONSOR or REIT shall not require SHAREHOLDERS to make representations in the subscription agreement which are subjective or unreasonable and which: a. might cause the SHAREHOLDER to believe that he or she has surrendered rights to which he or she is entitled under federal or state law; or b. would have the effect of shifting the duties regarding suitability, imposed by law on broker-dealers, to the SHAREHOLDERS.").

Finally, in Section C.3, the SOP requires that franchisors must include the following provision, or "legend," in its FDD and franchise agreement, or applicable state-specific addenda to the FDD and franchise agreement:

> 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.[32]

G. <u>How the NASAA Statements of Policies Impact State Franchise Laws</u>

NASAA, or its predecessor organization, has been part of the fabric of franchising since the 1970s, when some states and the FTC enacted franchise laws and regulations. Notwithstanding that NASAA is not a government agency, and franchise laws and regulations are adopted or modified by each state, NASAA has had a crucial role in the process of developing laws and regulations and interpreting those laws and regulations.

In 1975, NASAA, through its predecessor, the Midwest Securities Commissioners Association, drafted the first set of uniform pre-sale disclosure requirements for franchise offerings. These guidelines, referred to as the "UFOC Guidelines" were adopted by the states with statutes that required pre-sale disclosure for franchise investment offerings. Although the FTC had adopted its own set of franchise disclosure requirements in 1978, in 1979, the FTC affirmatively authorized franchisors to follow the NASAA UFOC Guidelines in lieu of the FTC's disclosure requirements.[33] NASAA revised these "old" UFOC Guidelines in 1986 to allow for disclosure of financial performance representations, then called "earnings claims," if those representations had a "reasonable basis."

In 1993, NASAA adopted revised franchise disclosures, which at the time were called the "new" UFOC Guidelines, and the FTC again affirmatively authorized franchisors to follow the NASAA "new" UFOC Guidelines in lieu of the disclosures required under the FTC Franchise Rule.[34] As a result, almost all franchisors began using the UFOC Guidelines to satisfy both federal and state franchise disclosure requirements. In 2007, the FTC adopted a final amended Franchise Rule (referred to in this paper as the FTC Franchise Rule). In July 2008, NASAA adopted the disclosure requirements of the amended FTC Franchise Rule, with minimal additional requirements, as the successor to the Uniform Franchise Offering Circular Guidelines adopted on April 23, 1994 (referred to in this paper as the "NASAA 2008 FDD Guidelines").[35]

Since 2008, NASAA has adopted other Statements of Policy on various issues, including for example, Financial Performance Representations, a Multi-Unit Commentary, and State Cover Sheets. In each case, states have followed and implemented the NASAA Statements of Policy

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[32] SOP Sec. II(C)3 at 7.

[33] 44 Fed. Reg. 49966, 49970 (August 24, 1979).

[34] 60 Fed. Reg. 51,895 (Oct. 4, 1995).

[35] N. AM. SEC. ADM'R ASS'N, 2008 FRANCHISE REGISTRATION AND DISCLOSURE GUIDELINES, https://www.nasaa.org/wp-content/uploads/2011/08/6-2008UFOC.pdf at introduction (2008).

in their review of Franchise Disclosure Documents without significant issues or problems. In 2020, the NASAA Franchise Project Group issued guidance on Disclosing Financial Performance Representations in the Time of COVID-19.[36]

Therefore, while NASAA has no direct authority over franchising in the United States, as an association comprised of representatives of the state securities administrators who administer franchise laws, NASAA's recommendations and policy initiatives have traditionally been given great weight by the states that regulate franchises.

Most states have statutory or regulatory provisions that expressly or impliedly grant the state's franchise regulators[37] discretion to interpret the FDD disclosure rules and add to or modify the FDD. As an example, Washington provides the following:

(1) The application for registration of the offer, . . . must be filed with the director and shall contain:

> (a) A copy of the franchisor's or subfranchisor's disclosure document which shall be prepared in compliance with *guidelines adopted by rule of the director*. The director shall be guided in adopting such rule by the guidelines for the preparation of the disclosure document adopted by the federal trade commission or the North American Securities Administrators Association, Inc., or its successor, as such guidelines may be revised from time to time; … *(f) Such other information as the director determines, by rule or order, to be necessary or appropriate to facilitate the administration of this chapter*.[38]

Under many state laws or regulations, the language that addresses the regulator's discretion, or ability to alter the prescribed disclosure rules, speaks to "additional" disclosures that the commissioner may require[39], or information that the commissioner may by "rule" prescribe.[40]

There are at least two states – Maryland and South Dakota – with laws that expressly acknowledge the commissioner's or director's role in "protecting" prospective franchisees in shaping the FDD disclosures. For example, the Maryland regulatory code provides:

> "The Commissioner may require the applicant to make such other disclosures as the Commissioner determines are necessary in the public interest and for the protection of prospective franchisees."[41]

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36 https://www.nasaa.org/wp-content/uploads/2020/06/FPRs-in-the-time-of-COVID-19.pdf.

37 The state's franchise regulator, or franchise regulator's office, is often referenced in the statutes as the "Commissioner" or "Director," and whose office is often the state's Securities Commissioner.

38 WASH. REV. CODE § 19.100.040(1) (emphasis added)

39 CAL. CORP. CODE § 31114: HAW. REV. STAT. § 482E-3(22); N.Y. GEN. BUS. LAW § 683.2(u).

40 HAW. REV. STAT. § 482E-3*(4); ILL. COMP. STAT. §§ 705/9 and 705/32; IND. CODE § 23-2-2.5-13.1(b)(6); WASH. REV. CODE § 19.100.040(1)(a) and (f). This latter formulation suggests that changes to the form of FDD must be developed and approved through the state's designated administrative regulatory or rule-making process.

41 MD. CODE REGS § 02.02.08.05 or 02.02.08.06(E).

The South Dakota law states:

> "The Director may require the franchisor to alter or amend the proposed disclosure document in order to assure a full and fair disclosure to prospective purchasers."[42]

It is clear, therefore, that states that regulate franchise offerings have discretion to interpret the disclosure requirements in the public interest and to ensure fair disclosure to prospective franchisee. NASAA has historically coordinated the registration states' efforts in this area through its Franchise Project Group. It is likely that states with an Anti-Waiver Provision or Anti-Fraud Provision will follow NASAA's lead and seek to implement the SOP beginning in 2023.

H. <u>How States May Implement the NASAA SOP</u>

As stated earlier in this Section, the Statement of Policy becomes effective January 1, 2023.[43] The SOP prohibits franchisors from requiring prospective franchisees to acknowledge or answer questions that are subjective, unreasonable, or simply repeat disclosures required to be stated in the FDD and requires a new legend to clarify that Questionnaires and Acknowledgments do not waive franchisee's claims under any applicable state franchise law. Whether a franchisor should file a Post-Effective Amendment to update its FDD or wait for renewal should be considered on a state-by-state basis after reviewing the requirements for material changes under each state franchise law. However, the franchisor should comply with the SOP when filing any application in a franchise registration state after the effective date.

I. <u>California Assembly Bill 676 (Holden)</u>

A related development that involves similar considerations underlying the NASAA SOP has taken place in California. On September 29, 2022, California's Governor signed Assembly Bill 676 into law, and it becomes effective January 1, 2023. Among other things this bill added a new provision to clarify California's anti-waiver provision.[44] This new provision supports NASAA's SOP and confirms that in California the NASAA SOP accurately clarified the legislative intent under its anti-waiver provision.[45] The California Franchise Investment Law ("CFIL") prohibits franchisors from asking franchisees to disclaim or deny the rights created by California law and any contract that does so is contrary to public policy, void and unenforceable.

Franchisors have relied on Questionnaires and Acknowledgments to protect the franchisor from claims of fraud in the franchise sales process. As early as 2007, it was noted that Acknowledgments on their face may defeat, as a matter of law, a claim that the franchisee relied on anything other than the information set forth in the FDD, since reliance has been expressly disavowed.[46] Asking a franchisee to disclaim or deny reliance is now contrary to public policy, void and unenforceable in California. Specifically, Corporations Code section 31512.1 states that

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[42] S.D. CODIFIED LAWS § 37-5B-6.

[43] Appendix 1.

[44] CAL. CORP CODE § 31512.

[45] CAL. CORP CODE § 31512.1.

[46] J. Michael Dady, Sandra J. Wall, and David J. Kaufmann, *Franchise Agreements: How Complicated Do They Need To Be?,* ABA 30TH ANNUAL FORUM ON FRANCHISING at 27 (2007).

a franchisor may not disclaim or deny reliance by franchisees on representations made by the franchisor, its agents or found in the FDD, representations made by the franchisor or its agents to a prospective franchisee or violations under the CFIL.

III. DISCLAIMERS, WARNINGS, ADMONITIONS, AND CAVEATS

Franchisors' use of disclaimers, warnings, admonitions, and caveats in various Items throughout the FDD, in addition to Item 19, is an issue that franchise regulators believe deserves further attention. Franchise regulators continue to see FDDs with statements that the regulators believe are inappropriate, unwarranted, or impermissible disclaimers. As such, state regulators are requiring the removal of, or significant edits to, these statements. The view of some (and quite possibly a significant number of) franchisors and their counsel, however, is that these statements are not prohibited "disclaimers" but are explanations, warnings, and admonitions that are beneficial to the reader, fulfill the goal of useful pre-sale disclosure, and are not prohibited by state franchise laws and regulations, the FTC Franchise Rule, or NASAA policies. This portion of the paper will review the differences between disclaimers and other statements, including certain references to the same in the FTC Franchise Rule and NASAA FDD Guidelines, and will provide examples of statements to which state regulators have raised objections.

As a preliminary matter, discussions of disclaimers in Item 19 FPRs and the issue of "disclaimers" versus "explanations" particularly in Item 19 FPRs and in Item 7 have been addressed in other presentations and papers at the ABA Forum on Franchising.[47] The fact that this issue is being addressed for the fifth consecutive year illustrates the continued use of disclaimers and explanations to which state regulators object and request removal. While Item 19 is often a principal focus of the regulators when objecting to disclaimers (and is addressed in other papers), we will address "disclaimers" identified by state regulators in other FDD Items.

A. <u>Disclaimers vs. Warnings, Admonitions, and Caveats</u>

Before we provide examples of disclaimers, warnings, explanations, etc., we wish to review the landscape upon which franchisors, counsel, and regulators operate, including what these terms mean, and the use of these terms in the FTC Franchise Rule, NASAA policies, and state laws and regulations.

According to Black's Law Dictionary, a "disclaimer" is "a statement that one is not responsible for or involved with something, or that one has no knowledge of it."[48] "Disclaimer", as it relates to franchising, is found in the "Prohibitions" section of the FTC Franchise Rule[49] which specifies prohibited actions or inactions by a franchisor. Specifically, a franchisor may not "disclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments.[50] NASAA's Commentary on Financial

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[47] Peggy Shanks & Lulu Gomez, *Regulatory Update*, ABA 44TH ANNUAL FORUM ON FRANCHISING W-13 (2021); Timothy O'Brien, Michelle Webster and Rochelle Spandorf, *Regulatory Update*, ABA 43rd ANNUAL FORUM ON FRANCHISING W-13 (2020); Dale E. Cantone, et al., *Regulatory Update*, ABA 42nd ANNUAL FORUM ON FRANCHISING W-16 (2019); Peggy Shanks et al., *Regulatory Update*, ABA 41st ANNUAL FORUM ON FRANCHISING W-22 (2018).

[48] *Black's Law Dictionary* (11th ed. 2019), *available* at Westlaw.

[49] 16 C.F.R.§ 436.9(f).

[50] 16 C.F.R. § 436.9(h).

Performance Representations discusses "disclaimers" in connection with representations in Item 19: "… franchisors may not include additional language that serves to disclaim the financial performance representation they have just made or state that a franchisee may not rely on the information presented."[51] The purpose of these prohibitions against disclaimers is to permit potential franchisees to rely on the information in the FDD. Disclaimers are not mentioned in other FDD Items.

While disclaimers may be prohibited, explanations to provide more accurate disclosures or background information to the potential franchisee are permissible. The FTC Compliance Guide states that "… nothing in the amended Rule would prevent a franchise seller from seeking alternative ways to narrow its disclosures to avoid making misleading statements."[52] In addition, certain state franchise statutes or regulations expressly require that FDDs include other information that a franchisor wants to provide.[53] To the extent explanations "explain" but do not "disclaim," potential franchisees will have the context to evaluate the information, and this should assist the potential franchisee in its due diligence process. Therefore, a crucial issue is whether a particular statement is a disclaimer or an explanation. The regulator authors agree this is a critical issue. If the disclosure is broad and applies generally to all businesses, a regulator will likely scrutinize it. It is therefore important that an explanation is specific to the franchise business and does not duplicate, mitigate, or contradict other disclosures.

B. <u>Warnings, Admonitions, and Caveats</u>

Warnings, admonitions and caveats (for ease of reference in this paper "WAC Terms") generally mean the same thing – "beware." Black's Law Dictionary defines these terms as follows: "warning" means "the pointing out of a danger, esp. to one who would not otherwise be aware of it;" "admonition" means "a warning….;" and "caveat" means "a warning or provisio."[54]

The FTC Franchise Rule discusses admonitions in connection with FPRs. Section 436.5(s) of the FTC Franchise Rule states that a franchisor must "include a clear and conspicuous *admonition* that a new franchisee's individual financial results may differ from the result stated in the financial performance representation (italics added)."[55] The FTC Franchise Rule is silent with respect to warnings and caveats.

The 2017 NASAA Commentary on Financial Performance Representations expanded on the FTC Franchise Rule's instruction on admonitions by stating that the only disclaimers, admonitions, or caveats that are permissible in Item 19 are the following sentences:

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51 N. Am. Sec. Adm'r. Ass'n, Nasaa Franchise Commentary Financial Performance Representations (2017), http://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf [hereinafter *FPR Commentary*].

52 Fed. Trade Comm., Franchise Rule Compliance Guide, at142, https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf [hereinafter *FTC Compliance Guide*].

53 *See* Haw. Rev. Stat. § 482E-3 (23); Md. Bus. Reg. Code § 14-216(a)(27); Mich. Comp. Laws § 445.1508(t); N.Y. Gen. Bus. Law § 683(2); 21 Va. Admin. Code § 5-110-95(7).

54 *Black's Law Dictionary* (11th ed. 2019) *available* at Westlaw.

55 16 C.F.R. § 436.5(s).

For Historical representations –

"Some [outlets] have [sold] [earned] this amount. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much."

For Projections representations –

"These figures are only estimates of what we think you may [sell] [earn]. Your individual results may differ. There is no assurance that you'll [sell] [earn] as much."[56]

That Commentary specifically states that: "In either case, franchisors may not include additional language that serves to disclaim the financial performance representations that they have just made or state that a franchisee may not rely on the information presented."[57]

The franchisor is left with trying to determine the difference between a WAC Term, a disclaimer, and an explanation. Franchisors and their counsel are often heard to say that in an attempt to eliminate any disclaimers, warnings, admonitions, or caveats, sometimes language is being deleted which would be helpful to the potential franchisee in evaluating the data and information, and in making a determination on whether to buy a franchise.

Many times, a franchisor will attempt to specify background factors which tend to explain, or arguably are intended to explain, facts, data, revenue, costs, or other information, usually in Items 7 or 19, but possibly elsewhere in the FDD. For example, economies of scales, brand name recognition, geography and possibly even weather conditions for seasonal type franchise businesses, can impact costs, timing and sales information. Arguably, these statements are not intended to diminish or disclaim the actual information which is provided in Items 7 or 19, but instead the franchisor wants to help a franchisee understand that these factors contributed to the sales level that these businesses achieved. With this information the franchisee may be more realistic about its ability to achieve sales figures or operate within the cost and expense ranges disclosed in Items 7 or 19 of the FDD. These sorts of explanations and admonitions can also be useful in defending against franchisee claims of misrepresentation, material omissions, or inaccurate disclosures. But their primary purpose (according to franchisors) is to explain and not as a liability shield. State regulators may view broad explanations that generally apply to all small businesses as prohibited or inappropriate disclaimers. The more specific the explanation and applicable to the specific franchise the more likely the regulator will agree that it is an explanation and not a disclaimer.

C. <u>Examples of Disclaimers, Warnings, Caveats and Explanations</u>

Certain statements are clearly disclaimers or should be generally regarded as disclaimers. For example, state regulators have seen FDD disclosures that explicitly state that a prospective franchisee should not rely on certain information. Also, there may be statements in an FDD that on their face are factual, or may be a warning. However, by examining the terms, wording, or context, the warning statements may contradict a previous statement, or may call into question the underlying basis for or the truth or the accuracy of previously disclosed information. Assume that the outlet build-out costs for a franchised business is based on the franchisor's only two company-owned outlets which were built in a lower-cost region of the country or were built several

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[56] FPR Commentary 19.3.

[57] *Id.*

years earlier under a lower cost structure. But the FDD is offering franchises for development in higher cost urban areas, or with a significantly larger square foot footprint. An explanation of that difference may shift from an explanation, caveat, or warning, to a disclaimer.

The harder questions, and the ones to highlight, are those statements that are not clearly disclaimers – or are not so clear to franchisors and counsel, but that they are identified as disclaimers by state regulators.

The following are examples of FDD statements[58] which state regulators have found objectionable, often citing them as impermissible "disclaimers."[59]

- In Item 7, the following is a note that is often included, usually as an explanation of the "Additional Funds" line-item expense, and/or an explanation of the total Item 7:

> "This estimates your start-up expenses. These expenses include payroll costs. [These expenses do not include payroll costs.] These figures are estimates and we cannot guarantee that you will not have additional expenses starting the business. Your costs will depend on factors such as how much you follow our methods and procedures; your management skills, experience and business acumen; local economic conditions; the local market for our product; the prevailing wage rate; competition; and the sales level reached during the initial period."

Some state regulators have objected to this entire note, and/or notes that contain similar explanations. Other state regulators may object to part of the note, and permit other parts, such as permitting only the third sentence that begins with "These figures are only estimates. . ."

As regular readers of FDDs, or counsel who prepare FDDs, will notice, this particular note is provided as a recommended and accepted "sample" Item 7 disclosure in the FTC Compliance Guide.[60] It has also appeared in many FDDs since the Amended FTC Franchise Rule was adopted in 2008.

Franchisors and counsel believe this is a necessary, justified, and useful warning and explanation that encourages the prospective franchisee to carefully evaluate the costs of this particular franchise business. Further, as this statement was part of the FTC Compliance Guide examples, many franchisors and counsel have questioned why it is objectionable.

The regulator authors note that state franchise laws offer more protections than the federal franchise rule. Further, the regulator authors' position is that this paragraph is problematic in that it mitigates the disclosure in Item 7 and the "explanation" is general and applies to all businesses. Many state regulators receive complaints where Item 7 is grossly inaccurate. The franchisor is required to provide accurate and not misleading information. In addition, this language shifts the

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58 The examples in this paper have removed franchisor or brand names, and do not identify the state or an examiner in the state. In some cases, the wording has been modified slightly for the purpose of illustration and confidentiality of the brand or business. Also, some of these examples were provided to Mr. Kirsch from franchise counsel in other law firms.

59 Some state regulator comments may say to remove or modify the statement, without an explanation or reason. In those situations, a franchisor or counsel may request an explanation or reason and/or provide a rationale for retaining the statement or modifying it in a different manner.

60 FTC Compliance Guide, at 50-51.

focus from accurate disclosure to a prospective franchisee's management skill and market conditions. Franchise regulators note that the FDD does not require or expressly permit a franchisor to disclose the desirable management skills or experience the franchisee needs to operate the business. Consequently, the regulator authors believe that in this context, this language from the FTC Compliance Guide acts as a disclaimer.

- In Item 7, a statement in the notes explaining the "Additional Funds" line item, that says:

> "The three-month time period is not a representation of, nor is it intended to suggest, when you should expect to break even."

As franchisors, counsel, and state regulators know, the "Additional Funds" line item and the initial period of operations mandated in Item 7 is not a break-even figure. The FTC in its Statement of Basis and Purposes stated that it was closely tracking the UFOC Guidelines, and wanted to eliminate concerns that, or implications that, the Additional Funds and initial operating phase was being represented as a break-even point.[61] However, prospective franchisees are not expected to know the details and nuances of the detailed requirements of the FTC Franchise Rule, the NASAA FDD Guidelines, the FTC's FAQs, NASAA commentary or the FTC Compliance Guide. Consequently, counsel for franchisors will likely view this note as a reasonable explanation to assist a prospective franchisee and help prevent it from reading Item 7 as a break-even figure. The regulator authors note that the FTC Franchise Rule prohibits franchisors from including in a disclosure document any information that is not required or expressly permitted, either by the FTC Franchise Rule itself or by state law.[62]

- In Item 7, a note at end of Item 7 regarding all of the Item 7 cost estimates stated:

> "We have never operated a [Brand X] franchise, and your costs may therefore vary significantly from our estimate."[63]

This note may be trying to provide a warning that a franchisee's costs could be higher than those disclosed in Item 7. However, it appears to call into question the accuracy or completeness of the Item 7 disclosures. Another requirement in Item 7 is to "describe in general terms the factors, basis, and experience that the franchisor considered or relied upon in formulating the amount required for additional funds." Unless other notes in Item 7 clearly explained the source of the Item 7 estimates (e.g., existing franchisees, bona fide proposals from contractors or equipment suppliers, etc.), this note appears to disclaim the accuracy of the Item 7 figures.

- In Item 6, a franchisee's monthly or weekly payment obligation is described (based on language in the franchise agreement) as a minimum payment of X% of revenue, or $Y. The note included in Item 6 stated:

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[61] 16 C.F.R. § 436, *Disclosure Requirements and Prohibitions Concerning Franchising*, 72 FR 15443,15487.

[62] FTC Compliance Guide, at 122. The FTC, in its Compliance Guide, expressly permits additional information if required by a state, as well as notes to clarify information. FTC Compliance Guide, pg. 122. See, also, the discussion, *supra*, at footnote 53 regarding five states that require additional disclosures required or requested by franchisors.

[63] This example was provided by one of the regulator co-authors of this paper.

> "The minimum weekly royalty payment of $Y is not intended to imply that you will experience revenue of any particular level."

The reason for such note is to warn the franchisee that it should not try to do a reverse calculation to arrive at an expected revenue figure. Also, if the franchisor did not have an Item 19 FPR, the note is also useful to avoid the appearance of a "back-door" FPR. In a vein similar to the comment regarding the Additional Funds note in Item 7 discussed above, the regulator authors note that the FTC Franchise Rule prohibits franchisors from including in a disclosure document any information that is not required or expressly permitted, either by the FTC Franchise Rule itself or by state law.[64] The franchise regulator authors recommend that if the franchisor is concerned that the prospective franchisee will use the minimum royalty as a break-even point or understand it to imply promised or expected revenue levels, the franchisor may choose to provide a financial performance representation. Franchise regulators may perceive this language as a disclaimer and ask for its removal or substantiation in Item 19.

- In Item 11, a statement regarding site selection, or the franchisor's approval or consent to a franchisee's choice of a location for the franchisee's business, included the following statement that state regulators requested be removed:

> "Our consent to the location of the franchised business does not infer or guarantee the success or profitability of the franchised business."

Franchisors or their counsel will include this statement to set expectations, and to clearly state that any site approval is not a guarantee of success. While it can be beneficial to a franchisor in a future dispute with a franchisee whose business did not realize its expected level of revenue or profitability, it does not appear to disclaim any statement or representation in the FDD or franchise agreement. The regulator authors note that Item 11 requires disclosure regarding the assistance a franchisor provides related to site selection. Including disclosures to set expectations is not required or expressly permitted, either by the FTC Franchise Rule itself or by state law so should not be added.[65]

- The following two statements were in Item 7 of two different FDDs, and state regulators requested that each statement be removed:

    - "By providing these estimates of your inventory costs, we are not making any representation that you will have any particular level of sales."

    - "Your inventory needs will vary substantially according to the size of the franchised business and the actual sales levels that you achieve during the initial period, which we cannot estimate."

Both of these are examples of franchisors trying to avoid making a "back-door" FPR. All franchisors and FDDs must include in Item 7 the cost of initial inventory (assuming that there will be inventory costs). It can be easy to calculate an estimated sales figures (depending on the nature of the inventory) based on the amount of inventory purchased and applying a specified price point for final product.[66] For some franchise brands that are product distribution businesses

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[64] Franchise Compliance Guide, at 122. *See also* discussion at footnotes 53 and 62 *supra*.

[65] *Id*.

[66] This may be easier for ice cream, for example, than all food products at a quick service restaurant.

or those that rely more heavily on product sales than a service brand franchise, the initial inventory costs can be significant, and the sale of products purchased from a wholesaler and resold at retail is the key revenue driver. In those situations, a note similar to the one above may be included to warn a prospective franchisee to not try to calculate sales based on inventory purchases. For the reasons, stated earlier, the regulator authors note that these disclosures are neither required or permitted under the FTC Franchise Rule or state law, so franchise regulators may comment and request removal.

The following are additional examples from various FDD and various industries in which the franchisor included an explanation, warning, caveat or admonition, and a state regulator requested its removal or modification.[67]

➢ Item 7: The following are statements from various FDDs regarding Item 7 notes or explanations that a state regulator requested be removed (and the regulator authors note that comments were likely made because the language was neither required or expressly permitted by the FTC Franchise Rule or state law):

- Remove: the statement that expenses listed are not within the franchisor's direct control and determined by economic conditions.

- Delete: that costs will depend on factors outside franchisee's control.

- Remove: "and you must make adjustments to your own initial investment estimate if any of these assumptions do not apply to you:"

- Remove: " . . . although we do not represent that these are the only categories of business expenses that you will incur during the 3 months after you start operations."

- Remove: "If you are a Conversion Franchisee, you must evaluate how much Additional Funds you will need beyond cash flow from your existing business to cover incremental expenses during the initial period specifically attributable to rebranding the business to the [Brand X] franchise in order to comply with our minimum specifications and operating requirements."

- Remove: "However, depending on your actual gross revenue, the royalty fees and brand fees that you pay during the 3-month initial period may be higher or lower than these minimum fees."

- Remove: "Costs may increase over time due to inflation and similar factors."

- Comment: the franchisor has excluded real estate costs, and the state regulator requested the inclusion of real estate costs (at minimum, lease costs) in the initial investment estimates and make the corresponding change to the FTC Cover Page.

[67] The examples that follow do not include point-by-point, or comment-specific explanations, as was done for many of the prior examples, because the explanations for including these statements, or removing these statements, are similar to the prior examples and discussion.

The state viewed real estate costs as a material disclosure, and omission of such disclosure may violate the state law.

- Remove: “Insurance costs vary according to your insurability and the location of the [Franchised Outlet].” “We make no representation that the minimum coverage that we specify will be sufficient for our business.”

- Remove: “We cannot estimate your cash flow from operations.” “We do not project what your actual Gross Sales will be. However, you should allow for these fees when you make your own calculations of working capital requirements.”

- Remove: “You should review the Item 7 figures and notes carefully with a business advisor before making any decision to purchase the franchise.” “You should not plan to draw income from operations during the start-up and development state of your franchise, which may be a period that extends beyond the first 3 months after you begin operations. You should have additional funds available in reserve, either in cash or through a bank line of credit or have other assets which you pay liquidate or against which you may borrow to cover other expenses, losses or unanticipated events during the start-up and development state of the Franchised Business and beyond.” (You may retain the statement, “We cannot guarantee that you will not have additional expenses or other categories of expenses to start the Franchised Business.”)

- Remove: the language that the costs are subject to potential increases over time.

➢ Other Items (1, 5, and 8): The following are examples of comments from FDD Items 1, 5, and 8, that have drawn state regulator comments:

- In Item 1, the state regulator requested the removal of the statement, “Your business will also be affected by its location, the locations of competing restaurant and other businesses, your financial and managerial capabilities, availability of labor, interest rates, changes in traffic patterns, demographic or cultural conditions, and other factors.”

- In Item 1, the state regulator requested that the franchisor remove a list of business risks that could affect the franchised business.

- In Item 5 the state regulator requested that the franchisor remove the language stating that existing franchisees who provide references to prospective franchisees are not the franchisor’s agent.

- In Item 8, the state regulator requested that the franchisor remove the language stating that franchisor’s approval of the site does not constitute an assurance of the suitability of the site for the franchised business.

As noted above, disclaimers, caveats, admonitions and warnings in Item 19 have been addressed in other papers in prior years, and the focus here was principally on other FDD Items. However, some examples of WAC Terms from Item 19 (or statements that are not clearly duplicative admonitions) are instructive as well. The regulator authors note that if language is added that duplicates, mitigates, or contradicts the FPR it will be scrutinized, and franchisors should not add language that calls into question the reasonable basis for the FPR.

➢ In Item 19, in describing the source of data obtained from franchisees to prepare the franchised outlet FPRs, the following statements[68] (in various FDDs) have been required to be removed.

> "The financial performance representation was prepared without an audit."
>
> "Prospective franchisees should be advised that no certified public accountant has audited these figures or expressed an opinion with regard to their contents or form."
>
> "The data was obtained from franchisee reports to us. We assume the data is accurate, but we have not verified it. We do not know if it was prepared using generally accepted accounting principles."

In most FDDs, FPRs are not financial statements, but rather specific data, such as gross or net sales, or a limited range of revenue and cost data. Therefore, FPRs are not financial information that can be subject to an audit. Franchisors will include statements similar to the ones above to put a prospective franchisee on notice as the source of data, and to warn the prospective franchisee of the limitations of the data. The statements do not disclaim the accuracy of the data, nor do they say that the franchisee cannot or should not rely on them. However, the regulator authors note again that these examples are neither required nor expressly permitted in Item 19. In addition, all franchisors are advised to take steps to be confident that the FPR has a reasonable basis. If a franchisor does not or cannot verify an FPR the franchisor should not make one.

Another factor to consider when reviewing these particular statements, is to look at them through the lens of a prospective franchisee in the context of the entire FDD, particularly if the FDD includes an <u>un</u>audited financial statement in Item 21. As counsel, regulators and franchisors know (but franchisees likely do not know), if there are unaudited financial statements in Item 21, some state laws or regulations require[69], and/or state regulators have required, that the FDD include a clear warning to the prospective franchisee that the financial statements were prepared without an audit. By not permitting a similar warning or notice in Item 19, the prospective franchisee reading Item 19 may think the figures are audited. The state regulator authors point out that the admonition is not required or expressly permitted in Item 21 of the FTC Franchise Rule or NASAA's 2008 FDD Guidelines. Franchisors should place the admonition on the first page of the interim financial statements and not in the body of Item 21. The state regulator authors further note that the admonition on the interim audit is there to distinguish it from an audit as they are in the same exhibit. Item 19 does not require and never contains audited financial statements, so no admonition is needed.

➢ In Item 19, if a franchisor provides a profit and loss statement, or a modified P&L for company-owned outlets and that FPR includes costs incurred by these company-owned outlets, the franchisor must include "imputed" fees that the company-owned outlets would have incurred had they been subject to the same franchise agreement provisions as the franchisees – such as an X% royalty or a Y% advertising fund fee.[70] One of the notes to Item 19 in an FDD, in explaining the imputed royalty figure, stated the following:

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[68] Some of these statements have been modified slightly to maintain confidentiality and provide illustrative examples.

[69] For example, *see* *MD. CODE REGS. § 02.02.08.13.D*.

[70] FPR Commentary para. 19.10.

> "You will be required to pay royalty fees, which are X% of gross revenue. Royalty fees are not paid by company-owned [Brand X] businesses. "**Imputed Royalty**" is the amount of royalty that would have been paid in each year, based on the standard X% royalty rate, for the gross revenues of each of the [Brand X] businesses. This calculation of imputed royalty, and this statement that explains it, is required by applicable franchise regulations, *but it is not a statement that you or any franchisee is expected to achieve the same level of sales*. It is intended only as a statement that if a [Brand X] business were to achieve the level of gross revenue that was achieved in each year by the company-owned businesses in the chart above, this is the amount of the royalty fee that would be owed to us."
>
> The language emphasized above ". . . but it is not a statement that you or any franchisee is expected to achieve the same level of sales" was requested to be removed.

The franchisor rationale for this note is to explain why the imputed royalty fee is included because, as noted above, most prospective franchisees do not know the detailed FDD requirements, and to remind the prospective franchisee that these particular level of sales should not necessarily be expected. The regulator authors note that the NASAA FPR Commentary provides guidance to the franchisor on how to make an FPR that has a reasonable basis. Neither the FTC Franchise Rule nor state law require or expressly permit this added language. The regulator authors believe that adding this language calls into question whether the franchisor has a reasonable basis for making a historic FPR. They also believe that the language is duplicative of the admonition that individual results may differ and that there is no assurance that you'll earn as much.[71] The NASAA FPR Commentary is clear that the franchisor may not vary the language of the admonition.[72]

As discussed in Section II above, state regulators have discretion to interpret their statutes and regulations for the protection of prospective franchisees.[73] So, whether or not there is an express prohibition on explanations or WAC Terms, the explanations and WAC Terms that state regulators view as disclaimers will continue to be the subject of comments and requests for removal or modification. Another consequence of the removal of some of these statements is that it will be more challenging for franchisors to defend against claims that a franchisee was misled by, or did not understand, the disclosures in the FDD. Conversely, it makes the franchisee's path to pursue these claims easier. The regulator authors note that the purpose of FDD is to provide each prospect with the information necessary to make an intelligent decision regarding franchise being offered. And language added in anticipation of franchisee disputes should not be included in an FDD unless required or expressly permitted.

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71 FPR Commentary paragraph para. 19.3.

72 FPR Commentary para. 19.21.

73 Cal. Corp. Code § 31114; Haw. Rev. Stat. § 482E-3*(4); Haw. Rev. Stat. § 482E-3(22); Ill. Comp. Stat. §§ 705/9 and 705/32; Ind. Code § 23-2-2.5-13.1(b)(6); Md. Code Regs § 02.02.08.05 or 02.02.08.06(E); and Wash. Rev. Code § 19.100.040(1).

D. Practice Tips

As discussed above, some statements are so blatantly disclaiming of prior or related disclosures, that a franchisor is essentially saying that a franchisee cannot rely on certain information. But many others are not so obvious.

For franchisors and their counsel, to avoid comments, or minimize the chance of receiving comments, from state regulators, the issue might be not what is said, but how it is phrased. For example, the following sentence was included in Item 19 of a franchisor's FDD: "If you hire a manager, your expenses will increase." A state regulator required that this sentence to be deleted because it was a disclaimer. It is possible that if the sentence was phrased differently, it may have been permitted. For example, an alternative statement might be: "There were no manager's salaries included in this FPR." That provides background information to the prospective franchisee, so if it wants to hire a manager, it must factor that information into the FPR information.

Another franchise counsel and two state regulators suggested, in the context of minimizing or reducing objections to Item 7 notes and comments, that franchisors and counsel should include robust and detailed descriptions of costs and assumptions in each of the various Item 7 line items, thereby reducing the need for a general or blanket explanation at the end of Item 7 that may be viewed as a general disclaimer.[74] In addition, to the extent explanations, warnings, and caveats are more brand specific, or industry-specific, as opposed to general risk statements that may apply to a wide range of businesses, state regulators may be more willing to accept these.

After receiving comments from various state regulators requiring that certain statements be eliminated, the franchisor and/or its counsel are faced with a more difficult task because franchisors are not required to have one uniform FDD for use in all states. While that is a desired goal for franchisors, multiple comments, some of which may be inconsistent from state-to-state, may force franchisors to choose alternative paths to secure a nationwide franchise sales program. The regulator authors note that using multiple FDDs may expose the franchisor to the risk of heightened scrutiny by federal or state franchise law enforcers.[75]

To address the conundrum of multiple state comments requesting the elimination of disclaimers, explanations or WAC Terms, a practitioner may consider the following approaches:

1. Do not challenge or object to any of the state requested or mandated changes, and accede to all states requests and make all such changes. This may require amending previously approved FDDs in another state to make them consistent with one particular state's comments.

2. Delete or change the problematic statement, but do so in the state law addendum. State specific changes are permitted to be included in the state law addendum for that state. Many state regulators will accept this approach. The FTC Compliance Guide specifically states: "As noted throughout these Guides, franchisors are permitted to include information that state law requires or permits in a disclosure document as long as the requirement is not inconsistent with the requirements of the amended Rule. For example, franchisors may include such information

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[74] Timothy O'Brien, Rochelle Spandorf, and Michelle Webster, *Regulatory Update*, ABA 43rd ANNUAL FORUM ON FRANCHISING W-13 (2020).

[75] FTC Franchise FAQ 38. Although FAQ 38 addresses variations in FPRs, and not warnings, admonitions, or other disclosures in an FDD, the franchise regulator authors believe that the same principles apply.

as state law specifies – in the cover page, in the body of the disclosure document, or as an addendum." The NASAA FDD Guidelines explain that multi-state disclosure documents are permitted by including all non-state specific information in the FDD itself and by adding a state law addendum as an exhibit.[76]

3. Include a paragraph which confirms that the provisions of the particular state franchise law override any possible waiver, warnings, admonitions, or caveats found in the FDD and any agreements in the state law addendum. Although this may not be necessary, as the state franchise law will always govern and cannot be waived, a state regulator may accept this approach.

4. Use separate state-specific FDDs. This was the practice in the 1980s and early 1990s before multi-state FDDs (or UFOCs), with integrated state-specific addenda, were permitted and accepted. While this is contrary to the goal of having one FDD for all states, with state-required changes included in a state law addendum, it is not prohibited. Such a practice may be cumbersome and possibly logistically difficult. It also increases the risk that a franchisor's salesperson may distribute the wrong FDD. However, with the use of electronic delivery of FDDs, the ability to easily name and identify state-specific FDDs in the electronic files of the franchisors, and the use of commercial franchise-specific document management software that can be activated or deactivated by state, the challenges to using state-specific FDDs are reduced. In addition, it will preserve the franchisor's desired disclosures in as many states as possible.

The regulator authors note that multiple comments are costly and cause delays. For this reason, the regulator authors encourage franchise counsel to review carefully what disclosures are required or expressly permitted in each Item of the FDD before adding warnings, admonitions, or caveats.

Anecdotally, in 2022, franchise practitioners have not seen a reduction in comments regarding disclaimers, WAC terms, or explanations. Based on past practice – with franchisors and practitioners including WAC terms and explanations that they believe are explanations and not disclaimers, and state regulators objecting to such statements without providing guidance regarding their interpretations of a "disclaimer" – practitioners are likely to continue to see such comments. The regulator authors note that much of the confusion over what is a disclaimer can be remedied by only including required or expressly permitted disclosures in the FDD.

IV. WASHINGTON COMMENTS ON "REASONABLENESS" OF FRANCHISE AGREEMENT PROVISIONS

Franchise practitioners have noticed over the past several years an increase in comments from the State of Washington. In addition to comments that other state examiners might make, such as a request to include a disclosure in response to a specific FDD Item instruction because it appeared to be missing from the FDD,[77] Washington franchise examiners also may request explanations and justifications of the "reasonableness" of franchise agreement provisions, or

[76] NASAA 2008 FDD Guidelines, Part IV.A.4.

[77] Washington franchise examiners will review FDDs and will provide these types of comments as well, but those are not the subject of this section of the paper.

explanations of how or why a franchise agreement provision is not unfair or burdensome to a franchisee.[78]

The comments are based on Washington Franchise Investment Protection Act ("FIPA") Section 19.100.180.[79] Section 19.100.180 is the provision of FIPA that governs the franchise relationship (as opposed to the disclosure and registration elements of other sections of FIPA). Section 19.100.180(1) requires that franchisors and franchisees "deal with each other in good faith."[80] Section 19.100.180(2) includes a list of ten actions or activities that are considered "unfair or deceptive" or an "unfair method of competition," and therefore they are "unlawful and a violation" of FIPA.[81] The list of unfair or deceptive acts addresses conduct or issues, some of which are present in "franchise relationship" laws of other states, such as the free association of franchisees; required purchases or leases of goods or services; discrimination between franchisees in charges for royalties and other items; exclusive territory conditions; refusal to renew without fairly compensating the franchisee for certain inventory and other items; and terminating a franchisee without "good cause." There are two subsections of 19.100.180 that seem to generate a significant number of comments. The first is the provision is in 19.100.180(1) which states:

> (1) The parties shall deal with each other in good faith."[82]

The second is § 19.100.180(2)(h), which states that it is unlawful to:

> (h) impose on a franchisee by contract, rule or regulation, whether written or oral, any standard of conduct unless the person so doing can sustain the burden of proving such to be reasonable and necessary."[83]

These two provisions (as well as subsections 19.100.180(2)(d) and 19.100.180(2)(j), regarding "fair and reasonable prices" and conditions regarding termination, respectively) are the basis for Washington examiners to question substantive franchise agreements provisions, and to request that the franchisor or its counsel justify a contract provision as being "reasonable," or in "good faith," or not an undue burden on the franchisee. Sometimes these comments may arise in the context of a disclosure in the FDD, but often they relate to the underlying agreement provision that is being described in the FDD.

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[78] The authors reached out to franchise examiners in Washington, and the Chief of Registration & Regulatory Affairs for the Securities Division of the Washington Department of Financial Institutions. We were provided with some background information on the Washington enforcement and FDD review process related to the issues in this section of the paper. However, there were no published articles or papers written by Washington examiners to which we could cite.

[79] WASH. REV. CODE § 19.100.180.

[80] WASH. REV. CODE § 19.100.180(1).

[81] WASH. REV. CODE § 19.100.180(2).

[82] WASH. REV. CODE § Cite to 19.100.180(1).

[83] WASH. REV. CODE § 19.100.180(2)(h).

The four most prevalent subject matters for Washington's "reasonableness" or "good faith" comments are:

- Transfer conditions imposed on franchisees
- The scope of post-term non-competition restrictions
- The fees, prices, or mark-ups charged to franchisees by the franchisors, affiliates, or suppliers
- Conditions or fees imposed at or upon termination

One particular area of concern for the Washington examiners relates to conditions that franchisors may impose on transfers. Many franchise agreements contain conditions that a franchisee must satisfy to secure franchisor approval of or consent to a transfer or assignment of a franchise agreement or franchised business, or a change in control or ownership of a franchisee. The Washington examiners evaluate these contract provisions, and have raised questions regarding a number of these conditions, such as requiring that the transferring franchisee (the transferor) guarantee the performance of the transferee. As noted in, or gleaned from the review of, comments from Washington, such a condition is, or may be viewed by the Washington examiners as, unreasonable and not made in good faith.[84] It is important to note, however, that with respect to comments on the transfer conditions, the Washington Department of Financial Institutions issued in 1991 a Franchise Act Interpretive Statement, FIS – 02[85], which set forth some guidelines regarding reasonable and unreasonable consents to transfer. So, franchisors have some guidance regarding potential comments, questions, objections from Washington.

Another franchise agreement provision that draws scrutiny from the Washington examiners are post-termination non-competition covenants. Under Washington law, like many state laws, post-term non-competes are enforceable if they contain reasonable temporal and geographic restrictions, and protect legitimate business interests of the franchisor.[86] The Washington franchise regulators may ask a franchisor or its counsel to explain how or why the non-compete provisions are reasonable under then-current Washington law and case law.

The Washington examiners will also scrutinize a franchisor's requirements regarding purchases or leases of products and services, and if applicable, the mark-up on such products. Franchisors are being asked to explain or justify that the prices and/or mark-ups being changed by the franchisor, affiliates or suppliers are "fair and reasonable." The likely reason for the increase in comments of this nature is a 2019 case in Washington, *Money Mailer, LLC v. Brewer*.[87] In *Money Mailer v. Brewer*, a Money Mailer brand franchisee brought counterclaims against the franchisor claiming that the price charged by the franchisor for printing products and services was illegal under FIPA, as the fees charged were unreasonable and included an excessive and illegal

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[84] The authors of this paper are not expressing an opinion as to Washington's position or action, nor do they suggest explanations or justifications for the franchise agreement provisions as responses to the Washington comments that are included below as examples.

[85] WASH. STATE DEP'T. OF FIN. INSTS., FRANCHISE ACT INTERPRETIVE STATEMENT – FIS-02 (1991), https://dfi.wa.gov/industry/franchise-act-interpretive-statements/franchise-act-interpretive-statement-fis-02.

[86] For a detailed discussion of non-competition covenants in franchise agreements under Washington law, see *Covenants Against Competition in Franchise Agreements* (Michael Gray & Natalma M. McKnew eds., 3d ed. 2012). Howard R. Morrill is the author of the Washington Chapter.

[87] 194 Wash. 2d.111, 449 P.3d 258 (2019).

mark-up. The Washington Supreme Court did not provide a bright line description of what is or is not fair and reasonable, but rather ruled that a determination of a "fair and reasonable price" under FIPA is a "question of fact," and included a list of factors to consider. Based on this ruling, Washington examiners are asking franchisors to explain that their pricing of products and services sold to franchisees are fair and reasonable.

The following are examples of comments from Washington[88] which request justification for the reasonableness or good faith of the franchisor's actions or franchise agreement provisions:

<u>Transfer Consent Related Comments</u>

<u>Example 1.</u> The Consent to Transfer provides that "The [Transferee/Franchisee] will bear liability for making improvements to the Franchise and the Franchise Assets as directed by Franchisor to meet Franchisor's then-current standards, and will pay all costs, fees and expenses related to, or arising out of the improvements." Please remove "Franchisee" from this provision or otherwise explain why such a requirement is reasonable and does not otherwise impose an unreasonable restriction on transfer.

<u>Example 2.</u> Section [#(X)] of the Transfer Agreement is unusual and appears to be an unreasonable restriction on transfer. Please explain why it is reasonable to require the franchisee to agree to the termination of the franchise as a condition of transfer and at the same time, expect the franchisee to continue to be obligated under guaranties they have executed when they will no longer have an interest in the franchise while the franchisor has consented to the transfer.

<u>Non-compete Comments</u>

<u>Example 3.</u> Under Washington law, non-compete covenants are enforceable only if they are reasonable and lawful. *See, e.g., Emerick v. Cardiac Study Ctr., Inc., P.S.*, 189 Wash. .App. 711, 721, *review denied*, 185 Wash. .2d 1004 (2016). Generally, a court determines the reasonableness of a covenant by analyzing its geographic and temporal restrictions. *See id*. at 724, 727-28 (in a cardiologist clinic case, the court held that a non-compete covenant preventing a formerly employed cardiologist from opening a competing clinic for four years anywhere within two miles surrounding the former employer-clinic was reasonable); *see also Armstrong v. Taco Time International, Inc.*, 30 Wash. .App. 538, 545 (1981) (in a Mexican food franchise case, the court held that a non-compete covenant preventing a former Taco Time franchisee from selling Mexican food for five years anywhere within the continental United States was unreasonable). Therefore, please explain the reasonableness of the geographic restrictions (XX miles) of the franchisor's post-term noncompetition covenant.

<u>Example 4.</u> In Exhibit A, Section [XX.Y] of the franchise agreement, we note that the franchisor prohibits franchisees, for a period of two (2) years following the expiration, termination, or transfer of the franchise agreement, from selling, assigning, leasing,

[88] Some of these examples were provided to one of the authors of this paper by franchisor counsel in different firms across the country. The brand names and sometimes other specifics have been removed or altered slightly to maintain the anonymous nature of the example. The references to costs, and other wording of the requests or comments, were not modified.

or transferring the premises to any entity or person that the franchisee knows intends to operate a "Competitive Business."

In your response, please clarify how this complies with RCW 19.100.180(2)(h), which prohibits a franchisor from imposing on franchisees any standard of conduct unless the person doing so can sustain the burden of proving such to be reasonable and necessary.

<u>Reasonable Fees and Charges Comments</u>

<u>Example 5.</u> In the Franchise Agreement, we note that the Franchisor requires franchisees to pay a monthly Technology Fee beginning the month in which the Franchised Business commences operations, and as consideration for payment of the Technology Fee, the franchisee shall be entitled to "a license to utilize any Software that Franchisor purchases for use by Franchisee, *if Franchisor elects to purchase or utilize such Software*." In your response, please clarify whether the Franchisor has purchased and/or currently utilizes Software. If not, then please clarify why the Franchisor believes that it is reasonable and in "good faith" in accordance with RCE 19.100.180(1) to require franchisees to pay a fee for which they are not receiving any corresponding benefits.

<u>Example 6.</u> The "Pre-opening salaries, travel, and initial training" line in Item 7 discloses that the high range for these costs is [$Y,YYY]. Footnote [X] to Item 7 states that:

> You will incur salary, travel, lodging, and food expenses. You will also incur expenses associated with our initial training program. For this training program, we provide instructors and instructional materials, but you must arrange and pay for transportation, lodging, and food for yourself and your employees to attend. You are also responsible for any wages for your employees. The cost will depend on the distance you must travel and the type of accommodations you choose. The amounts on the chart include the 3-month period following the opening of the Franchised Business. This investment is nonrefundable.

Please revise this range or explain in your response letter why, inclusive of pre-opening salaries, the estimate of these expenses is reasonable. Please also revise to clarify the expenses that are covered by Item 7, Footnote [X] or disclose them separately.

<u>Example 7.</u> Item 20 indicates that the number of franchised outlets in Washington has fallen from [XX] in 2019 to [YY] in 2021. Please comment on the reasons for this significant decline. In your response, please discuss any impact the *high royalty fees* may have had (italics added by the authors for this example). In addition, please provide information concerning any litigation threatened by former Washington franchisees who left the system in 2019 or later.

Termination Related Comments

Example 8. Item1 states:

> If the lease agreement or our agreement with the host facility were to terminate, your Franchise Agreement would automatically terminate.

In response to this letter, please explain how this provision complies with RCW 19.100.180 and RCW 19.100.180(2)(j) which states that it is an "unfair or deceptive act or practice or an unfair method of competition and therefor unlawful and a violation of this chapter for any person to . . . [t]erminate a franchise prior to the expiration of its term except for good cause . . . ."

Example 9. In Exhibit A, Section [XX.Y.Z] of the Franchise Agreement, we note that the Franchisor states that upon termination or expiration of the Franchise Agreement, at the Franchisor's option, the franchisee must sell to the Franchisor assets used to operate the Franchised Business, and that the purchase price for such items will be fair market value. For equipment that is five (5) or more years old, the parties agree that the fair market value is ten percent (10%) of the equipment's original cost.

In your response, please clarify how this comports with RCW 19.100.180(1), which requires a franchisor to deal with its franchisees in "good faith." Although we acknowledge that assets generally depreciate over time, a general rule to price these assets at ten percent of their original cost may not truly reflect the asset's "fair market value."

Example 10. Section [XX] of the Franchise License Agreement states that the franchisee will owe the franchisor a payment of 100% of gross sales for the previous year if the franchisee terminates the franchise agreement within three years of signing. While contracting parties are entitled to agree to liquidated damages, a provision in a contract that bears no reasonable relation to actual damages will be construed as a penalty. *See Wallace Real Estate Investment, Inc. v. Groves*, 124 Wn.2d 881 (1994). In response to this letter, please explain how this calculation bears a "reasonable relation" to the franchisor's actual damages. In the alternative, please revise the Washington Addendum and Amendment to state that this provision will not apply to Washington franchisees.

Other "Reasonableness" or "Unfair Practice" Comments

Example 11. In Item 7, we note that the Franchisor presents a low-end estimate of "$0" for "Vehicle" expenses, basing this low-end estimate on the assumption that a franchisee may already own a suitable white van in good condition. In your response, please clarify whether a typical franchisee already owns a suitable white van in good condition, otherwise please revise to present a more reasonable low-end estimate.

Practitioners' Questions

State franchise administrators have discretion in enforcing the state's franchise investment law. Washington is no exception.[89] Further, unlike many other states with "franchise relationship" laws that address the on-going franchise relationship (as opposed to pre-sale franchise investment and disclosure matters), the franchise relationship provisions of Section 19.100.180 are part of the same law (FIPA) that governs franchise registration and disclosure. Consequently, franchisors and their counsel, if they wish to secure registration in Washington, generally must provide sufficient justifications to the Washington franchise examiners. If they are unable to convince the Washington examiner of the reasonableness of the contract provision in question, they must either revise their franchise agreement or face the possibility of not securing registration and therefore not offering or selling franchises in Washington.

The situation franchisors face in Washington raises several issues. First, while recognizing the broad discretion afforded to the Washington franchise examiners under FIPA, as set forth in Section 19.100.040(1)(a), that subsection addresses disclosures in the FDD, and not substantive contract provisions. And the regulator authors note that the FDD disclosures are required to accurately disclose the substantive contract provisions under the FTC Franchise Rule. The authors have not seen, nor heard of, reported challenges to the Washington examiners on this ground.

A second issue that arises from Washington's action relates to the proper or appropriate party or government actor to determine whether a specific contract provision is fair, reasonable, enforceable, or in compliance with a statute. Generally, courts are the ultimate decision-makers to decide statutory interpretations and resolve issues of compliance with state statutes. The regulator authors note that the authority of the courts does not mean, however, that Washington franchise examiners have no authority to interpret the statutes, provided that the Washington legislature gave them authority to administer and enforce those statutes. A determination by a government regulator, with his or her own interpretation of a state law, and/or an interpretation of case law, strikes many franchisors and their counsel as misplaced or inappropriate. The standards for some of these issues, such as permissible non-competes restriction are not set out in the Washington statute or regulations. To illustrate this issue, the non-compete case cited by Washington in some of the comments, *Armstrong v. Taco Time International, Inc.* is the only reported decision of a Washington court that addresses non-competition covenants in franchising.[90] The Court in *Armstrong*, in rejecting a uniform mileage restriction, noted that a variable approach to non-competes was necessary to evaluate a proper "buffer zone." The fact that the Court acknowledges that non-competes are subject to various and varying considerations highlights the fact that issues regarding the reasonableness, and therefore the enforceability, of a non-compete are appropriately decided by a court. The regulator authors note that to further investor protection, the Washington franchise administrator has authority to determine compliance under the law too. Further, the standards for acceptable or enforceable non-competes may change over time, based on court decisions, and in some cases, changes in the statutes. The enforceability of a non-compete will be determined at the time the alleged competing activity is challenged in court, which could be many years after the franchise is offered or the franchise agreement is signed. Therefore, evaluating the enforceability of a non-compete before a franchise is even offered may be premature. The regulator authors note that determining

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[89] *See*, e.g., WASH. REV. CODE § 19.100.040.

[90] *Covenants Against Competition in Franchise Agreements* (Michael Gray & Natalma M. McKnew eds., 3d ed. 2012).

compliance with state law is a condition of a registration so must be determined when reviewing the registration application.

If a franchisor believes that a state regulator decision or action is not correct, the franchisor may challenge that decision via the appropriate state regulatory and court appellate process. However, many franchisors choose not to do so because of time and cost considerations, and the inability to offer and sell franchises in that state during the pendency of the challenge.

While the two issues discussed above are questions and issues that have been raised informally by franchise practitioners, the authors are not aware of any cases brought against the Washington Securities Division to challenge their authority. So, for now, these challenges remain theoretical.

Another approach, short of challenging the action or decision of a franchise regulator in court or through the state administrative adjudicative process, is for the franchisor or its counsel to suggest to the Washington franchise administrator that a comment, notice, or warning be included in the Washington addenda (of the FDD or franchise agreement, or both), so that the prospective franchisee will be on notice of the issue about which the regulator is concerned. As franchise practitioners know, some of the franchise registration states take this approach, by advising franchisees of issues related to one or more particular franchise agreement provisions that may be inconsistent with a state law. Some states will require that addenda to the FDD and/or the franchise agreement include a statement that a provision or condition in a franchise agreement may not be enforceable under that state's law, or may require a statement that state's law that may conflict with a franchise agreement provision.[91] This practice is currently part of the Washington franchise regulatory scheme, but it does not apply to all issues under Section 19.100.180. Washington's recommended "Washington Franchise Agreement Addendum[92] includes the following required statement:

> "RCW 19.100.180 may supersede the franchise agreement in your relationship with the franchisor including the areas of termination and renewal of your franchise. There may also be court decisions which may supersede the franchise agreement in your relationship with the franchisor including the areas of termination and renewal of your franchise."

In addition, Washington examiners have been known to permit certain statements in the Washington-specific FDD or franchise agreement addenda, to address Washington-specific issues or concerns. The regulator authors note that whether this approach is ultimately successful is within the examiner's discretion.

A related issue is the application of a Washington examiner's interpretation of Section 19.100.180 for exempt franchisors. If a franchisor, or the franchise offering, is exempt under FIPA, a Washington franchise examiner generally does not review the FDD or the franchise agreement. Therefore, a provision that may be scrutinized under a registration filing will not be reviewed if filed as part of an exemption. If we were to assume that there are two franchisors in the same industry with the exact same post-term non-compete provision, and that non-compete is one that a Washington examiner challenges or questions as being unreasonable or

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[91] *See*, for example, California, Illinois, Minnesota, North Dakota, and Washington. *See also* Beata Krakus et al, *My Addenda Say What? A Review of State Mandated FDD and Franchise Agreement Addenda*, ABA 39th ANNUAL FORUM ON FRANCHISING W-18 (2016).

[92] *See* www.dfi.wa.gov/sites/default/files/forms/franchise-agreement-addendum.pdf.

unenforceable, the franchisor that files for registration may be required to revise it, yet the exempt franchisor may include it in its franchise agreement and FDD. And the regulator authors note that the exempt franchisor may find that its failure to comply with state law may be the subject of litigation, or may subject the franchisor to a Washington enforcement action.

Finally, one of the reasons that the FTC and the registration states have adopted the FDD form for franchise disclosure[93] was for prospective franchisees to be able to review franchise offerings, whether across industries, or within the same industry, and to compare all sorts of information regarding each franchise brand, including the history of the brand, the experience of the management team, litigation history, etc., as well as fees charged and franchise agreements conditions. For example, if one franchise brand charges fees that are twice as much as another, a prospective franchisee can see that, conduct its diligence, and determine if the higher fee may be justified (or not) based on what is being provided, or other factors. The expected position of franchisors and their counsel (whether, for example, they have "high" or "low" fees, or conditions on transfers consistent with other brands or not) is that the FDDs will allow the franchisees and the marketplace determine which brand (if any) is the best choice for the prospect. Again, the regulator authors note that states are allowed to provide their investors greater protections than afforded by the FTC Franchise Rule, and therefore Washington is within its authority to require reasonableness and good faith terms if it believes the information and power imbalance in the franchisor-franchisee relationship makes it necessary for investor protection.

Unless or until Washington alters it approach to FDD review, franchisors desiring to sell franchises in Washington and their counsel will find themselves in a position of seeking to explain to the Washington examiners that specific franchise agreement provisions are fair and reasonable.

V. AMENDMENTS FOR THE SALE OF THE FRANCHISOR

Another issue that has come to fore for many franchisors and counsel is when to disclose the sale or possible sale of a franchisor, or a change in control of the franchisor. That is, when in the process of possibly deciding to sell or transfer ownership in the franchisor, or signing a non-binding letter of intent ("LOI"), or signing a binding LOI or sale agreement, or the closing of such a sale, has a material event occurred in which an amendment of the FDD in required.

The change of control of a franchisor is a "material event" that requires an amendment to Item 1 of the FDD, and the filing of a material change amendment in the franchise registration states.[94] Further, "materiality" is evaluated against the standard of a "reasonable prospective franchisee."[95] Both the FTC and some states define or explain "material" as facts or circumstances that have a substantial likelihood of influencing a reasonable franchise, or a reasonable prospective franchisee, in making a significant decision regarding the franchise.[96] Therefore, in

[93] Prior to the current FDD form, registration states required the Uniform Franchise Offering Circular (or UFOC) format.

[94] Change in control is specifically identified as a material event under the laws or regulations of many of the franchise registration states, including, for example, Hawaii (HAW. CODE R. § 16-37-1), Maryland (MD. CODE REGS. § 02.02.08.01)b)(9)), Minnesota (MINN. R. § 2860.2400(B), and Wisconsin (WIS. ADMIN. CODE DFI § 31.01(2)(b)).

[95] United States. v. Bldg. Inspector of Am. Inc., 894 F. Supp. 507 (D. Mass. 1995).

[96] 16 C.F.R. § 436, *Disclosure Requirements and Prohibitions Concerning Franchising*, 72 Fed. Reg.15443, 15455 (March 30, 2007). *See* examples of similar state definitions of materiality at ILL. ADMIN. CODE § 200.110 and MINN. R. § 2860.2400.

the vast majority of situations (if not nearly all situations), the sale of a franchisor or the change of control, certainly once effectuated, is a "material event." The issue of material changes has been addressed at length in several ABA Forum on Franchising papers/presentations[97], and in other franchise industry papers or programs. However, the issue being discussed in this paper is the point in time in the sale or change of control process that the material event has occurred.

The franchise regulator co-authors take the position that even when a franchisor signs a "non-binding" LOI to sell the franchise system, a reasonable prospective franchisee would consider that fact to be material, so best practice would be for the franchisor to either disclose that fact (most likely in Item 1 of the FDD), or the franchisor must cease selling franchises in the registration states until the FDD is amended, and the amendment is approved in those states. The co-author regulator view is that a franchisor is required to disclose who owns or controls the franchisor, and if there is going to be a change, or if there is the possibility of a change of ownership or control, that possibility must be disclosed.

A non-binding LOI may take different forms and may have varying provisions regarding the proposed transaction. It may have a proposed price, or range of consideration, but it may be open. It will likely include many conditions and caveats, to provide both sides room to negotiate and back out. Any transaction will be conditioned on the drafting, negotiation, execution, and closing of a definitive purchase agreement, following extensive diligence, and in some cases, securing third-party financing, and satisfying other contingencies. In some cases, a non-binding LOI is nothing more than an agreement to negotiate, without any commitment to consummate a transaction.[98] Even a non-binding LOI will identify a potential purchaser, and therefore it evidences the franchisor's desire to at least explore a sale or change of control transaction.

Based on the franchise counsel author's experience, as well as speaking with other franchise counsel involved in mergers, acquisitions, sales, and change of control transactions, and the existing professional literature and articles,[99] a common practice is to amend the FDD and disclose the change of control, or the potential change of control transaction, when there is an executed, binding, contract to sell the business or ownership interests, even if the transaction has not closed and/or is subject to pre-conditions to closing.[100] The practical, business, and legal reasons for doing so are discussed below.

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[97] Marisa Faunce et al., *Assessing Materiality – What to Include and When to Amend*, ABA 35TH ANNUAL FORUM ON FRANCHISING W-9 (2012). Stephanie J. Blumstein & Elizabeth M. Weldon, *Eureka or Gotcha Moment? Reliance, Materiality, and Loss Causation: Analysis of Key Elements of Franchisee Claims for Franchise Disclosure*, ABA 44TH ANNUAL FORUM ON FRANCHISING W-1 (2021); Genevieve A. Beck & Ellen R. Locker, *The Materiality Requirement for Franchise Terminations*, ABA 29th ANNUAL FORUM ON FRANCHISING W-7 (2006).

[98] While LOIs may have a provision to negotiate in "good faith," that obligation may not be binding and has no impact on whether a deal is ultimately consummated.

[99] Mark Kirsch and Charlene York, *The Role of Franchise Lawyers in Mergers & Acquisitions*, ABA 43rd ANNUAL FORUM ON FRANCHISING W-22 (2020); Alan R. Greenfield et al., *Mergers & Acquisitions The Basics of Buying and Selling the System*, ABA 40th ANNUAL FORUM ON FRANCHISING W-18 (2017); Andrae J. Marrococo, *Negotiating Critical Representations and Warranties in Franchise Mergers and Acquisitions – Part 1*, 36 FRANCHISE L.J. 1 (2016); P. Thoa Le et al, *Franchise Related Mergers & Acquisitions*, IFA LEGAL SYMPOSIUM (2014); Sandra Bodeau & Meg Montague, *Basics: Franchise-Related Mergers & Acquisitions*, IFA Legal Symposium (2016).

[100] This is based on the franchisor author's experience. However, the regulator co-authors believe that not all franchise counsel and franchisors take this position.

No two franchise systems, and no two franchisor change of control transactions, are the same. As many franchise commenters and counsel have said and written, there is “no bright line as to when a transaction must be disclosed and each transaction has unique characteristics.”[101] Notwithstanding the examples that follow to discuss materiality, the state regulator authors believe that best practice requires the franchisor to disclose or cease sales because a materiality analysis is not needed as the franchisor already has a duty to disclose under state and federal franchise law. But to examine the different nuances regarding when this material event occurs, we will posit two hypothetical franchise systems: (1) a founder-controlled franchisor, and (2) a financial sponsor (e.g., private equity fund) controlled franchisor. We will also examine different types of transactions, as these illustrate that there may not be a bright line test to establish the timing of the material event.

(1) Founder-Controlled Franchisor

Brand X franchisor is owned and controlled by the founders of Brand X, Ms. A & Ms. B, spouses, who have three adult children, two of which are active in the business. Ms. A, Ms. B, and the two children are identified in Item 2 of the FDD. The three adult children each own 10% of the franchisor, and Ms. A & Ms. B collectively own 70%.

(2) Financial Sponsor Controlled Franchisor

Brand Y franchisor is owned and controlled by private equity fund “F” (“PE-F” for this example). PE-F has three members of Brand Y Board of Directors, and the other two Board members are two of the original founders of Brand Y. Brand Y is managed by a group of experienced franchise professionals, including the CEO, CFO, Chief Development Officer, and Chief Marketing Officer.

The avenues that Brand X and Brand Y may pursue to find a buyer can be quite varied, but we will summarize a few alternatives for this discussion.

a. Founder Scenario #1: Brand X founders are approached, independently, by an investor that wants to buy ownership and control of Brand X. After months of discussion, Ms. A, Ms. B, and the investor **sign a non-binding LOI**, which if consummated in a sale will result in the investor owning control of Brand X.

b. Founder Scenario #2: Brand X founders seek out an investment banking firm (“IB”) to assist Brand X to market and sell the business, and that potential sale can be pursued in one of two avenues:

(i) by way of a multiple-party auction; or

(ii) by identifying one potential purchaser.

Brand X and IB **sign an agreement for IB to market Brand X to potential investors**.

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[101] Harris Chernow & Charles Modell, *Introduction to Practical Problems and Issues Associated with Buying and Selling a Franchise Company*, *in* MERGERS AND ACQUISITIONS OF FRANCHISE COMPANIES Ch. 1, 2d Ed. 2014).

c. Founder Scenario #3: Brand X Founders determine, in consultation with their children, that Ms. A & Ms. B will gradually withdraw from day-to-day operations of Brand X and will gradually transfer ownership to the children over the next five years. All five family members **sign an agreement and amend the Brand X company's organizational documents** to begin to implement this gradual change in control.

d. Founder Scenario #4: Brand X Founders, based on advice from tax counsel, and for estate planning reasons, **enter into an irrevocable trust** for the benefit of their children, and one of the assets transferred to the trust is the equity in Brand X. Ms. A & Ms. B continue to be active in the management of Brand X.

e. Financial Sponsor Scenario #1: Brand Y's financial sponsor, PE-F, determines that it is time to sell its interests, and is approached by another financial sponsor, or larger private equity firm ("G") ("PE-G"). After a period of discussion, PE-F and PE-G **enter into a non-binding LOI** to sell ownership in Brand Y to PE-G.

f. Financial Sponsor Scenario #2: Brand Y's financial sponsor, PE-F, seeks out an investment banking firm (as referred to above as "IB") to market Brand Y to potential buyers, in much the same way Brand X approached IB. Similarly to Brand X (in Founder Scenario #2 above), the sale can be effectuated through (i) a multi-party auction; or (ii) identifying one potential purchaser. **PE-F executes an agreement with IB to market and sell Brand Y**.

In the situations in which Brand X or Brand Y engage IB, there may or may not ever be an LOI. The process may go from soliciting bids, to negotiating with one (or more than one) bidder, and eventually to a signed equity purchase agreement.

In many franchisor or franchise systems sale transactions, the selling owners or the management of the selling franchise system will have management roles in the successor franchisor. In some cases, the selling founders will have roll-over equity in the successor entity. In particular, in a financial sponsor - to - financial sponsor transactions, the buyer (e.g., "PE-G") will often wish to retain a significant portion of the existing management team, because of the value that management brings to the franchise system. For the purpose of our illustrations, we will assume that there will be no management role for the Founders in the successor management in Founder Scenario #1, or at the end of the five years in Founder Scenario #2, but there will a continuation of some of seller's management team in the successor franchisor in all of the other scenarios.

The franchisor counsel author's experience is that many franchise practitioners tend to take a different view, particularly with financial sponsor – to – financial sponsor transactions. In many transactions, there is not a binding or non-binding LOI. Where there is a signed merger, equity purchase, or similar agreement, the execution of that contract is treated as the material event, and the FDD is amended or franchise sales cease,[102] even if there might be 30, 45, or 60 days until the transaction closes and the sale is consummated. Many prospective franchisees do not care, and would not notice, the difference between financial sponsors PE-F and PE-G, particularly if management remains. Franchise counsel have seen plenty of transactions collapse

[102] There are some situations in which buyer and seller agree to continue franchise sales during the pre-closing period, recognizing – but accepting – the risk. In many situations, the risk is deemed very low, based on a variety of factors. In those situations, the FDD is amended promptly after closing.

after an LOI has been signed, but before a definitive agreement is executed. Even bid or auction situations have collapsed or ended without a signed definitive agreement.

Another issue is the nature of the disclosure if there is only a non-binding LOI, as opposed to a fully executed and consummated merger agreement. After a franchisor sale, or change of control transaction (that is, after closing), the most typical FDD changes are in Item 1 (describing the new owners and the transaction); Item 2 (new officers and directors); Item 12 (if the buyer has other franchised or non-franchised concepts in a similar industry); and Item 21 (new financial statements if the transaction had a material change in the franchisor's financial condition). There may be other FDD changes as well.[103] Also, if the transaction is an asset sale, there will be an entirely new franchisor and a new FDD. However, if the material event is the signing of a non-binding LOI, or other pre-closing contract, there is considerably less to disclose. Other than identifying the potential purchaser, and disclosing that the transaction may never come to fruition, nothing can be said about management changes in Item 2, or any other potential FDD change because it has not happened, and those changes, if any, are not yet known. Also, in scenarios where there is not an LOI, but the selling franchisor may have signed a contract with an IB with an intent to sell, or interest in selling, if the agreement with IB is considered a material event, the franchisor has nothing meaningful to disclose, other than the fact that the franchisor is considering selling and is soliciting buyers or bids. There is not even a prospective purchaser to identify.

The state regulator authors believe it would be disingenuous though to not acknowledge that a non-binding LOI is a clear and unmistakable statement by the franchisor that it is amenable if not eager to be sold, which would result in a change in control, no less so than the decision of a franchisor to hire an investment banker to seek out a buyer. In that circumstance, there is a very high likelihood that by the time a prospective franchisee opens the doors, she or he will be dealing with a different ownership and management, as well as a franchisor with a materially different balance sheet, making the disclosures in the existing FDD meaningless as to their future experience.

If the franchisor (or the buyer) is a publicly-traded company, it is subject to prohibitions and restrictions on public statements under the securities laws, and may not be permitted to disclose a non-binding LOI. Of course, a "solution" to that dilemma of competing regulatory or legal requirements (such as a requirement or desire to disclose a material event under the franchise laws versus a prohibition on disclosure under the securities laws) is to not amend the FDD but to cease sales. That solution has its own challenges, because stopping franchise development may be a material change to the business which might need to be disclosed under the securities laws. Finally, the existing franchisor, Brand X or Brand Y in our examples, may wish to keep things confidential from certain staff and competitors. While that is not a legal reason to not treat a non-binding LOI as a material change, it is a practical consideration.

Another reason why many franchisors and counsel do not disclose a non-binding LOI as a material event in the FDD is that there is not significant jurisprudence and case law to merit disclosure. There are very few franchise cases on this topic. The seminal cases that deal with this issue are *O'Neal v. Burger Chef Sys., Inc.*[104], and *Vaughn v. General Foods Corp.*[105] In these

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[103] Mark Kirsch and Charlene York, The Role of Franchise Lawyers in Mergers & Acquisitions, ABA 43rd ANNUAL FORUM ON FRANCHISING W-22 at § III D.4.a, at 33-34 (2020).

[104] 860 F. 2d 1341 (6th Cir. 1988).

[105] 797 F. 2d 1403 (7th Cir. 1986).

cases, renewing franchisees claimed that the franchisor committed fraud for not disclosing a pending sale of the Burger Chef system to a competitor. The courts in these cases held that a franchisor does not have a duty to disclose this type of transaction, absent unique facts establishing a fiduciary duty or franchisee reliance.[106] However, in *Century Pacific, Inc. v. Hilton Hotels Corp.*[107] a new franchisee of the Red Lion chain sued Hilton after Hilton sold the Red Lion chain to a smaller competitor, West Coast Hospitality. During the franchise sales and development process when Red Lion was still owned by Hilton, a Hilton representative told the prospective Red Lion franchisee that Hilton intended to retain, and could promote, the Red Lion brand. The prospective franchisee purchased the franchise, and Hilton subsequently sold the brand to West Coast Hospitality. The franchisee sued for violations of the New York Franchise Law, common law fraud, and negligent misrepresentation. The court refused to dismiss the claims and appeared to accept the franchisees materiality claims. One fact that the court relied on in its decision was that the Hilton representative said that a sale was not imminent, which the court held established the reliance factor that was absent in the *Burger Chef* cases.[108]

The franchise regulator co-authors wish to express their view that civil cases do not control state or federal franchise enforcement actions. The requirement to accurately disclose material facts under state and federal franchise law should be distinguished from facts needed to establish fraud in a civil case.[109] The regulator co-authors wish to advise practitioners that a failure to accurately disclose material information, or the omission of a material disclosure, will expose franchisors to administrative liability under the state and federal anti-fraud statutes.

Turning to securities laws as an analogy to franchise laws, the franchise counsel author understands that the Supreme Court's decision in 1988 in *Basic, Inc. v. Levinson*[110] may provide some guidance for franchising. *Basic* blurred what was previously a bright line test from *TSC Industries, Inc. v. Northway, Inc*.[111] Under the prior *TSC* holding, an agreement-in-principle was not material until the would-be merger partners reached a definitive agreement on price and other key aspects of the transaction. While *TSC* did not involve a franchise system acquisition, but analogizing it to the franchise LOI discussion, the LOI would not be material or disclosable. But *Basic v. Levinson* rejected that formula, and the Supreme Court explained that materiality is based on an assessment of the probability that an event will occur and the significance of the event.

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[106] *See* Mark Kirsch and Charlene York, *The Role of Franchise Lawyers in Mergers & Acquisitions*, ABA 43RD ANNUAL FORUM ON FRANCHISING W-22 at p. 32 (2020); P. Thao Le et al., *Franchise Related Mergers & Acquisitions*, IFA LEGAL SYMPOSIUM (2014); Richard G. Greenstein & Joel R. Buckberg, *The Basics of Buying and Selling a Franchise Company*, ABA 28TH ANNUAL FORUM ON FRANCHISING W-11 at 45-46 (2005); David W. Kaufmann & David W. Oppenheim, *Selected Business and Legal issues in the Acquisition of Franchisors or Franchisees*, FRANCHISE L.J. at 147- 153 (2004).

[107] 528 F.Supp.2d 206 (S.D.N.Y. 2007).

[108] In Mr. Kirsch's experience, it is unusual, and some might say highly unlikely, that a franchisor that is considering selling its business or ownership interests would advise prospective franchisees that it had no plans to sell.

[109] *See* for example, cases that discuss potential common law fraud claims and negligent misrepresentation arising out of an alleged failure to make timely disclosures of a potential sale transaction. McLachlan v. N.Y. Life Ins., Co., 488 F.3d 624, 628 (5th Cir. 2007); Pearson's Pharmacy, Inc. v. Express Scripts, Inc., 5050 F.Supp2d 1272, 1275-76 (M.D. Ala. 2007); and Manhattan Motor Cars, Inc. v. Automobili Lamborghini, S.p.A., 244 F.R.D. 204, 212-13 (S.D.N.Y. 2007).

[110] Basic Inc. v. Levinson, 485 U.S. 224 (1988).

[111] 426 U.S. 438, 96 S.Ct. 2126 (1976).

While discussions with potential suitors and the possible sale, acquisition, or merger is likely to be considered significant, the second part of the analysis is the probability of whether the transaction will be consummated. In franchising, discussions with potential buyers are indicia of interest to sell, and so will an agreement with an investment banker. Even a non-binding LOI evidences an intent to sell. Therefore, the likelihood that such an event will be concluded or consummated, as represented by these preliminary contracts, becomes a critical issue. The results of this evaluation will often dictate the actions of franchisors and their potential acquirers, as well as the perspective of franchise regulators if called upon to consider whether a sale of a franchise system was properly and timely disclosed. While not a perfect analogy, the securities laws principles set forth in the *Basic* case provide a measure of guidance in the franchise context.

To sum up, the state regulators' position is that a prospective franchisee should know who owns and controls the franchisor (as required by the FDD disclosure requirements), and if there is a likely change in those facts, the prospective franchisee should be aware of it. The state regulators also note that a prospective franchisee is entitled to regard as material each and every statement in an FDD.[112]

What is a franchisor or counsel to do? One path is to disclose or amend as early in the franchise sales process as possible, and be prepared to "go dark" in the registration states during the amendment review, as well as addressing potential fall-out from existing franchisees. And if the transaction fizzles, the franchisor should be prepared for another amendment to remove the disclosure regarding the now-defunct sale, and to address additional franchisee questions and communications. Another path is to rely on the jurisprudence of disclosing material events in franchise system sales (which, as discussed above, is limited and does not provide bright line guidance), to carefully evaluate the likelihood of a sale transaction, as well as the information that can and should be disclosed, but only amend when there is sufficient reason to believe a definitive agreement will be signed. The state regulator co-authors note that this second path risks liability under state and federal franchise anti-fraud laws for omitting material facts in their FDD.

VI. CPAS AND FINANCIAL STATEMENTS

Another area where state regulators have noticed an uptick in non-compliance with the FTC Franchise Rule and state franchise law disclosure requirements is the submission of audited financial statements by auditors and audit firms that have not maintained their certifications to conduct and issue audits.

Item 21 of the FDD, under both the FTC Franchise Rule, and the NASAA FDD Guidelines, requires the submission of audited financial statements of the franchisor.[113] The rules require (with certain exceptions not relevant to this issue[114]) that "the financial statements must be audited by an independent certified public accountant." One aspect of this requirement is that the audit must be prepared by an independent certified public accountant or "CPA." In addition to the specific requirements of the franchise disclosure rules, CPAs must meet professional

[112] FTC Franchise FAQ 21: The text of the FTC Franchise Rule, as well as the Compliance Guide, make it clear that section 436.9(h) reflects a Commission finding that each disclosure required by the FTC Rule is material to a prospective franchisee's investment decision.

[113] *See* N. Am. Sec. Admins. Ass'n, 2008 Franchise Registration and Disclosure Guidelines, Item 21 instructions 1(iii), https://www.nasaa.org/wp-content/uploads/2011/08/6-2008UFOC.pdf; FTC Franchise Rule, 16 C.F.R. 436.5(u)(1)(iii).

[114] *See* FTC Franchise Rule 436.5(u)(2) regarding exceptions for start-up franchisors to disclosure under Item 21.

requirements imposed on accountants to maintain their accreditation and “certified” status through their state professional boards. The licensing authority and requirements for CPAs fall under the jurisdiction of the Boards of Accountancy for the state or jurisdiction in which a CPA practices.

The requirement to maintain the professional CPA license and requirement for CPA firms and individual CPAs who perform audits varies by jurisdiction. It usually includes continuing professional education. In addition, many jurisdictions require CPA firms and individual CPAs who perform audits or attestation services for clients to undergo peer review. In at one least one case, state examiners discovered that an accountant who audited financial statements for one franchisor had her license revoked by her state Board of Accountancy for a history of disciplinary actions. In several other cases, franchise examiners discovered individual CPAs have not been properly certified, and in other cases, that CPAs have lacked the required firm licensing.

The National Association of State Boards of Accountancy (“NASBA”) maintains a website, https://cpaverify.org/ that provides a list of the persons and firms that are licensed in participating jurisdictions. The Association of International Certified Public Accountants (“AICPA”) also maintains a list on its website, www.aicpa.org of AICPA members who have not maintained their CPA status. This list can be found under the “Peer Review Firm Terminations” header of the “For the Public” section of the AICPA’s website. (*See* https://us.aicpa.org/forthepublic/prfirmterm.html.)

State regulators can, and do, access the CPAverify.org and AICPA lists (any member of the public can do so). If regulators find that the audit included in the FDD was prepared by a firm or accountant that does not have a current certification, the regulator will issue a deficiency letter. In that case, the franchisor must either provide evidence that the CPA is licensed, and there was some error, or the franchisor must obtain a new audit by a certified CPA. In some cases, states may simply require that franchisors provide proof that the CPAs performing audits are properly licensed by their applicable state board of accountancy.

For many years, state franchise examiners did not check the status of CPAs performing audits. Once state examiners started checking the status of CPAs with CPA licensing authorities, the examiners identified a surprising number of alleged violations.

In the last few years, several states have taken action against franchisors that have used CPAs who were unlicensed at the time the CPA signed an audit report. These state actions have included requiring the franchisor to obtain and provide to franchisees new audited financial statements prepared by a properly certified CPA and then make rescission offers to franchisees who received the financial statements prepared by the unlicensed CPA.

State regulators have noted that they tend to see these audits by non-certified accountants in start-up franchisors. In addition, in at least one instance, state examiners began to notice that the same CPA, a sole proprietor, was showing up as the auditor in year-end franchise statements for dozens of different franchisors located all around the country during the same renewal season. Not surprisingly, when examiners referred these financial statements to accountants in their own offices, the state accountants identified errors in some of the financial statements. Many franchisors and franchisor lawyers filing FDDs with audited financial statements rely entirely on the CPAs to be both properly certified and competent to perform audits. State examiners no longer make those assumptions.

The selection of an auditor is a decision by a franchisor and not the franchisor’s counsel. The franchisor is a client of the auditor, and the franchise counsel does not hire or retain the auditor. However, franchisor counsel can advise their clients of this current concern, and can advise their franchisor clients to confirm with their accountants – before they engage them to do the audit – that the accountant is certified. Of course, the franchisor and counsel can check the AICPA website themselves.

Franchisors and their counsel should remember that the state regulators regularly communicate with their peers in other states. When they see a filing that raises questions, they often contact their counterparts in other states, especially regarding issues with uncertified accountants. So, for a situation such as an uncertified accountant providing an audit, it is likely that if one state discovers this and sends a deficiency notice to the franchisor, other states will follow.

VII. FRANCHISE ELECTRONIC FILING DEPOSITORY SYSTEM ("FRED")

In 2021, NASAA launched a multi-state online application filing platform known as the "Franchise Electronic Filing Depository" system, also known informally as "FRED," to be a one-stop filing portal and database for state franchise filings. FRED was an expansion of an existing online platform, the Electronic Filing Depository System ("EFD) that NASAA established in 2014 to accept electronic submissions of state securities applications. The EFD has been very successful with respect to securities filings, and, consequently, expanding into the franchise area was the next logical step. As a result of the COVID-19 pandemic, with more people working remotely, including state regulatory personnel, the importance and ease of using the EFD system has greatly increased. State franchise regulators had been urging NASAA to allow franchise filings through EFD for many years. The NASAA Franchise and Business Opportunity Project Group first approached NASAA with the idea of developing a franchise-specific electronic filing portal more than twenty years ago, but the initiative was stalled based on concerns about cost and the complexity of developing such a system. It was only after NASAA successfully implemented EFD for certain securities applications that the expansion to franchise filings became feasible.

Since its initial launch in April 2021, FRED has proved to be an efficient method of processing franchise filings, tracking the progression from submission to state approval, and providing the public access to the information about the franchise programs available.

A. <u>What Does FRED Do?</u>

FRED is a portal to submit franchising filings for single or multiple states. Franchise filings include initial franchise registrations, and renewals and amendments to an existing franchise registration, different types of exemptions, terminations and withdrawals of registrations, and submissions of advertising. In addition, FRED can be used to respond to state franchise regulators' comment letters. FRED also can be used for some Business Opportunity law filings. FRED will notify the individual who is filing the documents ("Filer") of the progress of the state filing, notify the Filer of any comment letters or additional requests from the state regulators, track all changes in the state franchise laws and state regulators' requirements relating to franchise filings, and provide the public with access to view all franchise relating filings in FRED. FRED also can be a convenient storage and tracking solution for the Filer.

Currently there are nine states that accept franchise filings through FRED – California, Illinois, Maryland, New York, North Dakota, Rhode Island, South Dakota, and Virginia, as well as Nebraska, which has a "franchise" exemption filing under the Nebraska Business Opportunity Law. At present, two states, New York and North Dakota, will only accept filings through FRED. New York may accept applications by mail if an application for hardship is submitted prior to filing.

Other states (Nebraska, South Dakota, Virginia, and Maryland) will permit either paper filings to the state regulators' offices and/or through FRED. California and Rhode Island will accept filings either through FRED or their own respective state online portals. There are a number of other states that are currently considering using FRED to accept franchise filings, including Indiana, Michigan, Minnesota, Washington, and Wisconsin.

FRED will collect the appropriate state filing fees on behalf of the state and also will charge and collect a FRED-specific administrative fee for use of the portal. Currently, the FRED administrative fees, per state, are $100 for initial filings, and $50 for renewals, amendments, and notice filings. The administrative fee to use FRED is payable in addition to the applicable state filing fees for the applications filed. However, each first-time filing submitted through FRED will be billed at $100 per state. Currently, these state fees and FRED fees must be paid by using a bank ACH.

B. <u>Nuts and Bolts of Using FRED</u>

NASAA's EFD can be accessed at the following website: https://www.efdnasaa.org/.

Using FRED, like any other portal or website, has a learning curve, but the website is relatively user-friendly. To use FRED, the Filer must create one account. This account can be used for multiple franchisors' filings in multiple states. Once a Filer signs into EFD, the Filer is on the "Filer Home Page." Through this page, one can access the franchise portion by clicking the tab at the top right corner entitled "Franchise." Under this tab is a menu which includes action tabs labeled "new," "in progress filings," "active filings," "inactive filings," and "cart."

- "New" is where the Filer enters the information for a franchisor that has not yet been established within FRED.
- "In progress filings" will list all of the Filer's franchisors which have filings that are pending. A click on the name of the franchisor will bring up a screen which contains the states where filings have been made and whether the application in those states has been accepted, submitted, or resubmitted. A click on the state name will display another screen with further details about the documents filed in each state, comment letters from the regulators, and acceptance letters.
- "Active filings" will list all of the franchisors for which Filer has submitted documents on its behalf. Though this tab, the Filer can access the same information as through the "in progress filings" tab.
- "Inactive filings" contain a list of franchisors for which Filer has submitted documents on its behalf.
- "Cart" is the payment tab.

FRED will send notifications when the filing is assigned to a state regulator, when a comment letter is issued, when a response to the comment letter has been submitted, and when an approval has been granted. FRED only notifies the primary email on the account, which is the Filer. It will not send notices to, for example, the franchisor and the franchisor's outside counsel, as only one can be the "Filer." A Filer may access comment letters through FRED. Some states also will send comment letters and approval letters directly to the Filer in addition to posting these letters on FRED. In addition, if a franchisor determines to change counsel handling state registrations, or take the process in-house and file itself, the Filer and the Filer information can change. Either the previous law firm Filer, or the new Filer (the new law firm or the franchisor) must submit a reassignment of ownership notice to EFD support (support@efdnasaa.org) and EFD Support will move the data to the new Filer.

In preparation for a filing, a Filer will see that FRED will list the types of documents that are required for each state. This list is kept current. Once a document is posted to FRED, it will be available to be used by that franchisor for additional states and in the future. It is helpful that all of the documents filed are stored on FRED for future reference.

FRED keeps track of the current filing fees for each state. If a Filer is using the franchisor's bank account for the ACH payment, it will send the Filer and any individual the Filer designates from the franchisor to be notified of such payment. The franchisor will then have a copy of the payment for its files. This should eliminate the need for the Filer to wait for paper checks to be sent by the franchisor and/for the Filer to advance funds on behalf of the franchisor.

C. Key Advantages to Using FRED

Some of the benefits of FRED include:

- FRED significantly reduces the amount of paper used in filings. No paper copies are required. Filing through FRED is better for the environment, saves trees, and frees up storage space, at Filer's office, and creates a more efficient filing document management process.

- State forms no longer need to include original signatures, and the forms can be scanned by the franchisor to the Filer. This saves time and money by eliminating the need for overnight mail to send the original signed forms to Filer.

- FRED will only permit a Filer to submit documents for a filing in a particular state if all required forms for that filing are included. This should expedite the filing process and reduce the number of comments regulators must make about missing forms or documents.

- FRED maintains current filing fee information for each type of filing. This saves the filer time from researching filing fees and provides confidence that the payment amount is accurate.

- Submissions to the state are deemed filed upon uploading all the required documents into FRED and paying the full fee amount. This allows filers more time to meet filing deadlines and avoid delays that occur shipping large paper documents.

- FRED creates a history of each filing, including notification of comment letters and approvals. The Filer can access the status of any filing by logging in to their account.

- Once documents are downloaded to FRED, they are available to be used for other registration states, so the Filer only needs to upload them once.

- FRED offers online storage for all of the Filer's franchise documents.

- For Filers with multiple brands, the FRED website eases the filing burden by having one website with one username and password instead of separate state filing portals with multiple usernames and passwords.

- FRED is supposed to send reminder notifications before a registration lapses. A notice is supposed to be included in the "Franchise Registration Expired or Expiring Soon" section of the weekly email sent to the filer. However, it should be accessible to the Filer as a "warning message" in the "In Progress Filings" queue.

D. Public Access

FRED also permits public access to many of the documents which are filed on FRED, and FRED contains a searchable database which can be used by the public. Although the name of the documents can be viewed by the public, not all documents are available to be viewed by the public or downloaded by the public. All effectively registered FDDs filed through FRED are available for viewing by the public, however, each state can set its own standards for the types of documents available to be viewed.

To search for an FDD filed through FRED, a person can go to the following website, https://www.efdnasaa.org/Franchise/Search , then click the "Search" button on top. The next step is to click "Franchise Search". There is a search bar where one can enter the EFDID, Franchise Name, Franchisor Name or State File Number.

E. Problem Solving

Based on informal discussions with members of the franchise bar, the EDF support team has been responsive to requests for help. There is a "Support" menu on the top of the screen. A click on "EFD Support" will generate the telephone number 601-453-1979, an email address (support@efdnasaa.org), and a place on the screen to type in a question which will be sent to EFD directly. The Support Hours are also listed. Although sometimes a call is not answered immediately, all messages left are usually answered that day. The support team has been very knowledgeable and helpful. Also, on the EFD Support Page is a list of Filer User Manuals which are kept updated. NASAA is currently working on posting a specific manual for Filers who use FRED, although, as of the date of this paper, that manual was not yet posted on the EFD Support website.

F. Roll Out of FRED

NASAA formally announced that it would begin to accept franchise registration filings through FRED on April 26, 2021, near the end of the 2021 franchise renewal "season." Not surprisingly, Filers made relatively few filings using FRED in 2021. Filers have begun using FRED more frequently in 2022, particularly during the 2022 franchise filing renewal season, and there have been relatively few reported glitches reported.

As of July 25, 2022, NASAA reported that Filers submitted a total of 5,684 franchise filings through FRED (5,255 of which, or 92%, were filed after January 1, 2022). Of the 5,255 total franchise filings filed through FRED between January 1, 2022 and July 25, 2022, 3,584 filings were finalized (for example, "registered," made "effective," "accepted," or "filed," depending on the state parlance).

Of the 5,684 total franchise filings filed through FRED as of July 25, 2022, 1,365 are classified as initial applications, 2,803 are classified as renewal applications, and 405 are post-effective amendments. FRED also received a total of 956 exemption filings of varying types, including renewals and amendments of previously filed exemptions. FRED also received a variety of miscellaneous franchise filings, including 42 “Franchise Expo” exemptions, 17 advertisements, 2 annual reports, and 2 franchise seller disclosure filings.

Maryland’s experience with FRED illustrates just how quickly Filers have accepted the new electronic filing system. Maryland is one of several states that allows but does not require franchise filings through FRED. In the first six months of 2022, Maryland reports that it received significantly more filings through FRED than by any other means (hand delivery, private courier, and the U.S. Mail). Specifically, 58.37% of all Maryland franchise applications between January 2, 2022 and June 30, 2022 were made through FRED compared with only 41.63% of filings made via other means. This trend occurred with every category of filing. Maryland reports also that the first six months of 2022 was one of the busiest six months for franchise applications to date, with a total of 1,422 franchise applications filed during that period. In contrast, Maryland reported total franchise filings of 1,239 in the first six months of 2021 and only 1,136 in the first six months of 2020.

As more Filers and the state regulators learn the ins and outs of this online platform, the minor problems Filers have experienced with the new systems should be resolved. Some states seem to be responding to or approving renewals quicker than in previous years, particularly for filing submitted in February and March 2022. However, anecdotally, other states seem to be taking as long – if not longer than usual – to respond to filings and response to comments. For many Filers, submitting filings through FRED is a more streamlined in the seven participating (franchise) states than using paper filings or through separate online state portals. The eventual goal is to expand the number of states that will participate in FRED so it becomes a one-stop filing portal for all state franchise filings.

G. <u>Expectations for 2023 and Beyond</u>

NASAA is hopeful that states who have not yet accept franchise filings through FRED will adopt and implement FRED before the 2023 franchise filing season. The NASAA Franchise and Business Opportunity Project Group will continue to press NASAA to consider allowing payment of fees to FRED using credit cards, not just by ACH. Finally, NASAA will continue to make minor adjustments and enhancements to the FRED portal as issues arise.

VIII. CONCLUSION

There have been several important developments in state franchise regulation in 2022. State regulators have continued to be proactive to ensure that prospective franchisees receive relevant information about a franchise offering and do not waive important rights that state legislatures intended them to have under state franchise laws. Among the most significant developments in franchising was the adoption by NASAA of a Statement of Policy on Questionnaires and Acknowledgments. Although it remains to be seen how states will implement this policy, it is likely to generate additional comments by examiners that franchisors must anticipate and resolve before registering a franchise offering.

Examiners also have continued to issue comments for franchisors to remove what examiners view as unlawful waivers and disclaimers from both disclosure documents and franchise agreements. Washington examiners also likely will continue to question substantive contractual provisions that may potentially violate that State's franchise relationship provisions.

Franchisor attorneys should consider relevant state anti-fraud statutes that can impact when a potential change in ownership of a franchisor entity must be disclosed to potential franchisees. Franchisor attorneys also may need to ask more questions about the Certified Public Accountants their clients employ to ensure that the accounts are both properly licensed in the jurisdictions they operate and competent to audit franchise financial statements. Finally, the development and refinement of the NASAA-sponsored franchise electronic registration portal, "FRED," should make it easier and more efficient for franchisors to comply with different state franchise filing requirements in 2023.

APPENDIX 1

NASAA STATEMENT OF POLICY REGARDING THE USE OF FRANCHISE QUESTIONNAIRES AND ACKNOWLEDGMENTS

(Adopted September 18, 2022)

I. Introduction

This Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments was prepared by the Corporation Finance Section ("Section") and the Franchise and Business Opportunities Project Group ("Project Group") of the North American Securities Administrators Association, Inc. ("NASAA") to set standards for the proper use of questionnaires and acknowledgments in franchise offerings.

Background

Federal and applicable state franchise laws require a franchisor to make certain pre-sale disclosures to prospective franchisees. The disclosures are made with a Franchise Disclosure Document ("FDD") consisting of 23 items of information, with applicable attachments, including the franchise and other related agreements.

Over at least the last 30 years, franchisors have included in their franchise agreements and FDDs language that they can later use as a disclaimer of liability. One type of disclaimer takes the form of a series of acknowledgments ("Acknowledgments") in the franchise agreement regarding the franchise offering. In addition, many—but not all—franchisors require prospective franchisees, at or prior to signing a franchise agreement, to mark "yes" or "no" to a series of questions or agree to a series of representations about what purportedly occurred, or did not occur, in the franchise sales process ("Questionnaires"). Virtually all Questionnaires and Acknowledgments address whether a prospective franchisee received some type of financial performance information different from what the franchisor disclosed in Item 19 of its FDD.

Franchisors routinely seek to use Questionnaires, Acknowledgments, and other forms of contractually required disclaimers to insulate themselves from potential liability by franchisees alleging fraud or misrepresentations in the offer and sale of a franchise.[1] Some have been successful.[2]

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[1] *See, e.g., Martrano v. Quizno's Franchise Co.*, No. 08-cv-0932, 2009 WL 1704469, at *5 (W.D. Pa. June 15, 2009) ("Defendants pointedly assert, in their December 2008 Motion before this Court, that 'Each Plaintiff was asked directly to disclose any representation he had received other than those contained in the UFOC. In the space provided, each and every one of the plaintiffs wrote 'None'.'"); *Siemer v. Quizno's Franchise Co.*, No. 07-cv-2170, 2008 WL 904874 (N.D. Ill. Mar. 31, 2008) (franchisor's defense based in part on disclosure acknowledgment statement through which franchisee was put on notice of potential business risks).

[2] *E.g., Governara v. 7 Eleven, Inc.*, No. 13-cv-6094, 2014 WL 4476534 (S.D.N.Y. Aug. 20, 2014) (granting franchisor's motion to dismiss plaintiff's claims under the anti-fraud provisions of the New York Franchise Act based in part on non-reliance disclaimers executed by the plaintiff).

The Practical Effect of Acknowledgments and Questionnaires

By the time prospective franchisees are presented with a franchise agreement or Questionnaire to sign, many are emotionally and financially invested in completing the transaction. As one commenter has noted, "[N]obody buys a franchise in a vacuum. They typically do so after being convinced of the attractiveness of the brand, the strength and utility of the franchisor's system, the support they will receive from the franchisor, and the enthusiasm they encountered at Discovery Day. None of these factors are the result of reading an FDD."[3]

Questionnaires and Acknowledgments are not the most effective mechanisms for preventing fraud.[4] They are, however, powerful defense mechanisms that franchisors can use to defeat claims of fraud and misrepresentation regardless of what has occurred in the franchise sales process. As a result, Questionnaires and Acknowledgments can allow unscrupulous franchisors to avoid the consequences of franchise fraud. Although at least one court has opined that Questionnaires and Acknowledgments can be useful to help franchisors "root out dishonest sales personnel and avoid sales secured by fraud,"[5] they do so by shifting the compliance burden from franchisors to prospective franchisees. It should be the franchisor's burden to police its own sales personnel and agents; franchisees should not have to confirm that no violations of law have occurred during their own sales process.

The FTC Franchise Rule's Position on Franchise Waivers, Disclaimers and Questionnaires

In 2007, the Federal Trade Commission ("FTC") promulgated an amended FTC Franchise Rule that included a limited ban on disclaimers made in the FDD itself and its exhibits or attachments. When the FTC promulgated the FTC Franchise Rule, it did not specifically address a franchisor's use of Questionnaires or the effect of Acknowledgments on franchisee fraud claims. In 2019, the FTC announced it was soliciting public comments on the FTC Franchise Rule. One issue the FTC raised related to the impact the FTC Franchise Rule has had on the flow of truthful information and on the flow of deceptive information to prospective franchisees.[6]

In the years since the FTC promulgated the FTC Franchise Rule, Questionnaires and Acknowledgments have become commonplace in franchising, and some commenters have

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[3] S. Dub, B. Napell, D. Oates, "Dueling Perspectives on Selected Franchise Agreement Provisions," American Bar Association 43rd Annual Forum on Franchising, at 20 (October 27-30, 2020), available at https://www.americanbar.org/content/dam/aba/events/franchising/2020/w18.pdf.

[4] *See, e.g., Braatz v. Red Mango*, 2015 WL 1893194 (N. D. Tex. Apr. 27, 2015), aff'd sub nom. *Braatz, L.L.C. v. Red Mango FC, L.L.C.*, 642 F. App'x 406 (5th Cir. 2016) (Franchisees allege they changed their answers in Questionnaire about receiving financial information because the franchisor told them that they could not open the franchise without the Questionnaire being completed in the form the franchisor required); Comment of Anonymous, posted by the FTC on December 10, 2020 ("While I signed a questionnaire saying I didn't rely on information outside of that disclosure document, that was not true, however, I knew that would preclude me from making the franchise purchase if I answered truthfully"), available at: https://www.regulations.gov/comment/FTC-2020-0064-0042.

[5] *See Emfore Corp. v. Blimpie Assocs., Ltd.*, 51 A.D.3d 434, 435 (N.Y. App. Div. 2008).

[6] *See* Disclosure Requirements and Prohibitions Concerning Franchising, Federal Trade Commission, 84 Fed. Reg. 49 (Mar. 13, 2019), available at: https://www.govinfo.gov/content/pkg/FR-2019-03-13/pdf/2019-04466.pdf.

argued that the FTC should now address or even prohibit them. Those commenters point out that Questionnaires and Acknowledgments limit a franchisee's ability to hold a franchisor accountable for fraud and deceit, irrespective of the underlying facts of a franchisee's claims.[7]

Although the FTC held a public workshop in 2020 to explore issues related to both Questionnaires and Acknowledgments,[8] the FTC has not yet directly addressed whether or when those provisions violate the FTC Franchise Rule.

The Impact of State Franchise Law Provisions

Several states have enacted franchise registration and disclosure laws that include protections for prospective franchisees that are not found in the FTC Franchise Rule.[9] Modeled on securities anti-fraud laws, these state franchise laws include provisions that prohibit any person from committing fraud, making untrue statements of material fact, or omitting to state a material fact regarding a franchise offering ("Anti-Fraud Provisions"). Most of those same statues also include provisions ("Anti-Waiver Provisions") that prohibit or render void any provision or condition requiring a prospective franchisee to agree to a release, waiver or estoppel that would relieve a person from liability under that law.[10]

Although not all courts agree, many courts have concluded that franchise contractual disclaimers, including Questionnaires and Acknowledgments, violate state Anti-Waiver Provisions when they serve as a release or waiver of a franchisee's rights under a state franchise law.[11] For example, in *Randall v. Lady of America*, the franchisor argued in a motion for summary judgment that a contractual integration clause and certain disclaimers were sufficient to

[7] *See, e.g.*, Comment from Bundy Law Firm, PLLC, at pp 7-9, posted by the FTC on December 21, 2020, https://www.regulations.gov/comment/FTC-2020-0064-0118; comment from Lagarias, Napell & Dillon, LLP, at pp. 8-14, posted by the FTC on December 17, 2020, https://www.regulations.gov/comment/FTC-2020-0064-0077.

[8] A transcript of the November 20, 2020, workshop is available at: https://www.ftc.gov/system/files/documents/videos/reviewing-franchise-rule-workshop-discussion-disclaimers-waivers-questionnaires/franchise_rule_workshop_transcript_-_discussion_of_disclaimers.pdf.

[9] *See* Cal. Corp. Code §§ 31000 through 31516; Haw. Rev. Stat. § 482E-1 through § 482E-12; 815 Ill. Comp. Stat. §§ 705/1 through 705/44 ; Ind. Code §§ 23-2-2.5; Md. Bus. Reg. Code §§ 14-201 through 14-232; Mich. Comp. Laws §§ 445.1501 through 445.1546; Minn. Stat. §§ 80C.01 through 30C.22; N.Y. Gen. Bus. Law Art. 331 §§ 680, et seq.; N.D. Cent. Code §§ 51-19-01 through 51-19-17; R.I. Gen. Laws §§ 19-28.1-1 through 19-28.1-34; S.D. Codified Laws §§ 37-5B-1 through 37-5B-53; Va. Code Ann. §§ 13.1-557 through 13.1-574; Wash. Rev. Code §§ 19.100.010 through 19.100.940; Wis. Stat. §§ 553.01 through 553.78.

[10] *See* Cal. Corp Code § 31512; Haw. Rev. Stat. § 482E-6; 815 Ill. Comp. Stat § 705/41; Ind. Code § 23-2-2.7-1; Md. Bus. Reg. Code § 14-226; Mich. Comp. Laws § 445.1527(b); Minn. Stat.§ 80C.21; N.Y. Gen. Bus. Law Art. 33 § 687(4); R.I. Gen. Laws § 19-28.1-15; S.D. Codified Laws §37-5B-26(8); N.D. Code § 51-19-16(7); Va. Code Ann. § 13.1-571(c); Wash. Rev. Code § 19.100.180(2); Wis. Stat. § 553.76.

[11] *See Coraud LLC. v. Kidville Franchise Co., LLC*, 109 F. Supp. 3d 615, 621 (S.D.N.Y. 2015) ("[New York's anti-waiver statute] bars anticipatory waivers of compliance with the NYSFA's anti-fraud provisions."]); *Hanley v. Doctors Express Franchising, LLC*, No. 12-cv-794, 2013 WL 690521, at *29 (D. Md. Feb. 25, 2013) ("Construed as waivers of plaintiffs' misrepresentation claims under the Maryland Fraud Law, the disclaimers are legally void."); *Randall v. Lady of Am. Franchise Corp.*, 532 F. Supp. 2d 1071, 1089 (D. Minn. 2007) (holding that a disclaimer that has the effect of waiving compliance with the anti-fraud statute's prohibition of material false statements is void under the anti-waiver statute); *but see Governara*, 2014 WL 4476534, at *6-7 (holding anti-waiver statute did not void contractual reliance disclaimer; declined to follow by *Coraud*).

defeat a franchisee's claims under Minnesota's Franchise Act. The court disagreed, holding that the Anti-Waiver Provision of the Minnesota Franchise Act invalidated the contractual disclaimers. The court reasoned that the historical truth of a franchisor's misconduct (in this case, that the franchisor made unlawful earnings claims) could not be negated by a contractual disclaimer without violating the Anti-Waiver Provision. The court explained:

> The disclaimer cannot change the historical facts; if the dishonest franchisor made misrepresentations, then he made misrepresentations, no matter what the franchise agreement says. Thus, the disclaimer can only be an attempt to change the *legal effect* of those misrepresentations. That is precisely what [the Minnesota] anti-waiver language forbids.[12]

Similarly, in *Hanley v. Doctors Express*, the court held that disclaimers and acknowledgments contained in a franchise agreement and FDD were legally inoperative to bar a franchisee's claims under the Maryland Franchise Law based on the Anti-Waiver Provision of that law to the extent that they would operate as a release, waiver, or estoppel.[13] The court relied, in part, on the statement of purpose for the Maryland Franchise Law, which was enacted in response to substantial losses suffered by franchisees when the franchisor or its representatives had not given complete information. The court noted that, given the Maryland General Assembly's clear statement of intent, waivers and releases of a plaintiff's rights under the Maryland franchise laws are void as such clauses violate a fundamental policy of the state.[14]

In the opinion of the Section and the Project Group, Questionnaires and Acknowledgments violate state Anti-Waiver Provisions when they are used as contractual disclaimers that release or waive a franchisee's rights under a state franchise law. Courts that have found otherwise have not recognized or appreciated the history and purpose of state franchise registration and disclosure laws. The state legislatures that enacted these franchise laws intended to protect franchisees from the effect of contractual disclaimers, including those that may take the form of Questionnaires and Acknowledgments. The prospective franchisee who signs a Questionnaire or series of Acknowledgments and later denies the accuracy of what was signed would have to explain such a discrepancy, but they should have that opportunity before a factfinder, rather than have their claims dismissed based solely on having signed a Questionnaire or series of Acknowledgments.

<u>Inappropriate Questionnaire and Acknowledgment Provisions</u>

State regulators have observed that Questionnaires and Acknowledgments currently found in some FDDs and franchise agreements are replete with questions and representations that serve no legitimate purpose. Many Questionnaires and Acknowledgments require a prospective franchisee to acknowledge or answer questions that are subjective, unreasonable, or repeat disclosures required to be stated in the FDD. In some cases, Questionnaires require the

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[12] *Randall*, 532 F. Supp. 2d. at 1088-89.

[13] *Hanley*, 2013 WL 690521 at *29 (the court noted that integration clauses and waivers are not necessarily wholly irrelevant, citing the issue of reliance).

[14] *Id*. (citations omitted).

prospective franchisee to acknowledge identical facts and statements that the franchisee must acknowledge a second time in the franchisor's franchise agreement. In other cases, these Questionnaires and Acknowledgments require prospective franchisees to agree that they understand specific disclosures made in an FDD or the terms of the franchise relationship. These provisions are inconsistent with plain English standards and the legislative policies behind state franchise laws, which were passed to protect prospective franchisees by requiring presale disclosure. State franchise laws do not allow FDDs to be used as a defense documents that serve to protect franchisors who commit fraud or make misleading material disclosures or material omissions.

II. Application of Statement of Policy Regarding the Use of Franchise Questionnaires and Acknowledgments

This Statement of Policy applies to Questionnaires, Acknowledgments, and similar documents that appear in FDDs and applicable attachments and exhibits used in the offer and sale of franchises where an Anti-Waiver Provision or Anti-Fraud Provision applies to the offer or sale.

A. Definitions

This Statement of Policy uses the following terms defined in the NASAA 2008 Franchise Registration and Disclosure Guidelines.

Franchisee - Franchisee means any person who is granted a franchise.

Franchise seller - Franchise seller means 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, subfranchisors, 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.

Franchisor - Franchisor means any person who grants a franchise and participates in the franchise relationship. Unless otherwise stated, it includes subfranchisors. For purposes of this definition, a "subfranchisor" means a person who functions as a franchisor by engaging in both pre-sale activities and post-sale performance.

Person - Person means any individual, group, association, limited or general partnership, corporation, or any other entity.

Prospective franchisee - Prospective franchisee means any person (including any agent, representative, or employee) who approaches or is approached by a franchise seller to discuss the possible establishment of a franchise relationship.

B. Attachment to FDD

1. If the Franchisor requires the Prospective franchisee to sign any Questionnaires, Acknowledgments, or similar documents before entering into the franchise agreement, the proposed form of such Questionnaires,

Acknowledgments or similar documents must be referenced in Item 22 of the FDD and attached as an exhibit.

2. If the Franchisor requires the Prospective franchisee to verbally respond to any Questionnaires, Acknowledgments, or similar statements on video or other electronic media recording before entering into the franchise agreement, a written script of the proposed form of such Questionnaires, Acknowledgments or similar statements must be referenced in Item 22 of the FDD and attached as an exhibit.

C. Prohibited Provisions in Questionnaires and Acknowledgments

1. The Franchisor and its Franchise seller(s) shall not require the Prospective franchisee to make any statement in any Questionnaires, Acknowledgments, or similar documents that is subjective or unreasonable or that:

    a. Would cause a reasonable Prospective franchisee to surrender or believe that they have surrendered rights to which they are entitled under federal or state law;

    b. Would have the effect of shifting Franchisor's disclosure duties under federal or state law to the Prospective franchisee; or

    c. Are otherwise Prohibited Statements under this Statement of Policy or are similar to the Prohibited Statements.[15]

2. Prohibited Statements in Questionnaires, Acknowledgments, and similar documents include, but are not limited to, the following:

    a. That the Prospective franchisee has read or understands the FDD or any attachments thereto, including the franchise or other agreement.

    b. That the Prospective franchisee understands or comprehends the risks associated with the purchase of the franchise.

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

    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.

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[15] This Statement of Policy is not intended to prohibit a Franchisor from conducting factfinding or asking Prospective franchisees questions about the sales process, but Franchisors may not require a Prospective franchisee to document and sign statements that act as waivers in violations of state law.

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.

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

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

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

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

j. That the Prospective franchisee agrees or understands that the Franchisor is relying on the Questionnaires, 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.

k. That requires or suggests that the Prospective franchisee 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.

3. Franchisor must include in its FDD and franchise agreement, or applicable state-specific addenda to the FDD and franchise agreement, the following provision:

   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.

APPENDIX 2

NASAA Policy on Questionnaires and Acknowledgments and Public Comments as of January 5, 2022

No.	Commenter (individual, firm, or entity)
1.	Akerman LLP
2.	American Association of Franchisees & Dealers
3.	Baker, Donelson, Bearman, Caldwell & Berkowitz, P.C.
4.	Bundy Law Firm, PLLC (Carol B. Fichter)
5.	Bundy Law Firm, PLLC (Howard E. Bundy)
6.	Cheng Cohen LLC
7.	Coalition of Franchisee Associations
8.	Dady & Gardner, P.A. (Andrew A. Malzahn)
9.	Dady & Gardner, P.A. (Jeffrey S. Haff)
10.	Davis Wright & Tremaine LLP
11.	DLA Piper LLP (US)
12.	Dub, Stanley
13.	Faegre Drinker Biddle & Reath LLP
14.	Franchise Research Institute
15.	Franchise Truth
16.	Franchisee Advocacy Consulting
17.	Garner, Ginsburg & Johnsen, P.A.
18.	Greenfeld, Peter N. - Law Offices of
19.	Greensfelder Hemker & Gale, P.C.
20.	Holzman, Bruce
21.	International Franchise Association
22.	Kent Franchise Law Group
23.	Laffey, Leitner & Good LLC

No.	Commenter (individual, firm, or entity)
24.	Lagarias, Nappell & Dillon, LLP (Bruce Nappell)
25.	Lagarias, Nappell & Dillon, LLP (Peter C. Lagarias)
26.	Larkin Hoffman Daly & Lindgren Ltd.
27.	Lathrop GPM LLP
28.	Libava, Joel
29.	Moore, Brandon
30.	MSA Worldwide
31.	Pacific Management Consulting Group
32.	Plave Koch PLC
33.	Polsinelli PC
34.	Schonberger, Arne
35.	Texas Hose Pro
36.	Witmer, Karp, Warner & Ryan LLP
37.	WorldWise Franchise Development
38.	Zarco, Einhorn, Salkowski & Brito, P.A. (Robert M. Einhorn)
39.	Zarco, Einhorn, Salkowski & Brito, P.A. (Robert Zarco)

Author Biographies

DALE CANTONE

Dale Cantone currently is a Senior Assistant Attorney General at the Maryland Attorney General's Office. From 1999 to 2021, Dale was Deputy Securities Commissioner for Maryland and the chief of the Franchise and Business Opportunity Unit of the Securities Division of the Maryland Attorney General's Office. In addition, from 1997 to 2021, Dale served as Chair of the Franchise and Business Opportunity Committee/Project Group of the North American Securities Administrators Association, Inc. ("NASAA").

Dale has spoken at programs sponsored by the International Franchise Association, the American Bar Association Forum on Franchising, the International Society of Franchising, the American Franchisee Association, the American Association of Franchisees and Dealers, the Direct Sellers Association, the United States Department of Commerce, the Maryland State Bar Association, the Maryland Institute for the Continuing Professional Education of Lawyers, the New York Attorney General's Office, the University of Maryland Law School, the U.S. Hispanic Chamber of Commerce, the Better Business Bureau, the International Franchise Expo, and the Coalition of Franchisee Associations. Dale also has spoken about U.S. franchising issues to foreign delegations from Australia, Russia, Japan, China, and Romania.

In 2021, Dale was recognized with the Robert Purvin Legacy Award by the American Association of Franchisees and Dealers. In 2002, Dale testified about state franchise issues before the Commerce, Trade and Consumer Protection Subcommittee of the Energy and Commerce Committee of the U. S. House of Representatives. In 2001, NASAA presented Dale with its Outstanding Service Award for his work in franchising at the state level.

THERESA LEETS

Theresa Leets is the Assistant Chief Counsel in the Franchise Unit of the Department of Financial Protection & Innovation's Legal Division. She is responsible for supervising the Department's program under the Franchise Investment Law. Last year the Department regulated over 1.6 trillion dollars in securities and franchise transactions. The Department processed over 55,000 exemption notice filings, 2,400 applications and collected over $20 million dollars in fee revenue.

Theresa speaks frequently on topics related to both franchise and securities law. She is the Chair of the North American Securities Administrators Association's (NASAA) Corporate Finance Section's Franchise and Business Opportunities Project Group. She serves as a Trustee for the Los Angeles County Bar Association (LACBA) and is the recipient of LACBA's Samuel L. Williams Outstanding Trustee Award. Theresa is also a licensed California real estate broker with an inactive Mortgage Loan Origination (MLO) endorsement. She is the first franchise regulator to earn a Certified Franchise Executive (CFE) designation from the International Franchise Association.

MARK A. KIRSCH

Mark Kirsch is a partner at Lathrop GPM LLP in Washington, D.C. For over 35 years, Mark's practice has focused on domestic and international franchising, licensing and distribution, including transactional and regulatory matters, and mergers and acquisitions. Mark's clients range from large national and international chains to emerging systems, across a wide range of industries, including restaurants, hotels, health care, education, and various retail product and service businesses.

In 2021, Lathrop GPM launched *Increasing Diversity in Franchising*, a virtual speaker series designed to increase ownership in franchising by underrepresented racial and ethnic groups – as both franchisees and franchisors. As co-leader of the effort, he invests significant time and effort into making these events successful and impactful, and these have spawned other programs and collaborations with industry groups and colleges to increase diversity in franchising.

Mark is active in the franchise industry, including past service as chair of the International Franchise Association's Supplier Forum, and he was also a member of the IFA's Board of Directors. He has been a frequent author and speaker at ABA Forum on Franchising seminars, and at IFA and other industry programs, about a variety of issues including branding, licensing, franchising, and distribution. Mark's recognitions in the franchise and legal community include Chambers USA, America's Leading Lawyers for Business, the International Who's Who of Business Lawyers, and Best Lawyers in America. Mark received his B.A. in Economics from the University of Rochester, and his J.D. from The George Washington University.

Note: Mr. Kirsch wishes to thank Marilyn Nathanson, Counsel at Lathrop GPM, Jay Harrington, a 3L student at Washington University in St. Louis School of Law, and a Summer Associate Law Clerk at Lathrop GPM in the summer of 2022, and Scott Raver, Manager of Research Services and Knowledge Management at Lathrop GPM, for their invaluable assistance in researching, editing, and preparing portions of this paper.