Franchise and Distribution Frequently Asked Questions

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In addition to its franchise litigation practice, the Wiggin and Dana Franchise and Distribution Practice Group regularly assists clients with regulatory and transactional matters, including the creation of franchise programs, updating and amending franchise agreements and related documents and offering circulars, filing first time franchise registration applications and renewals and responding to regulators' comments, reviewing the possible coverage of state business opportunity laws and filing appropriate exemption notices or applications, reviewing and filing where appropriate franchise development advertising and day-to-day business counseling. From time to time we will share with you questions that arise in our practice that have general application and may be of interest to you.

1. **Question:** We recently completed our annual update of our offering circular and filed for renewal of our registration in all the registration states. We use one multistate offering circular throughout the country, reflecting the required state disclosure differences and franchise agreement changes in an addendum to the offering circular. Most of the states accepted our renewal as submitted, but a few states provided comments, asking us to change disclosures not only in the state addendum applicable to their state, but also in the body of the offering circular that has already been approved by the other states. Do we have to amend our registration in the states which have already approved our updated offering circular to reflect the changes requested by other state regulators?

Answer: Usually you do not have to file an amendment, provided the requested changes are not material. We consider clarifying the existing disclosure or adding information or negative disclosures required by the Uniform Franchise Offering Circular Guidelines but inadvertently left out, to be minor changes. We also endorse fixing minor typos even if not spotted by the regulators. The established informal procedure is to provide a copy of the revised offering circular incorporating all state comments to the registration states as a courtesy, with a cover letter stating that another examiner has asked for changes and you are providing a copy of the revised offering circular as a courtesy. We recommend sending a set of marked pages showing the changes as well as one complete clean copy of the revised offering circular. Typically the states will not acknowledge or otherwise respond to these filings.

2. **Question:** What are the rules regarding redisclosure when the offering circular is amended? For example, if after a prospect receives the offering circular and is considering the system, we amend the offering circular, do they have to be redisclosed and sign a receipt for the revised offering circular and wait the ten business day cooling off period before they can sign the franchise agreement?

Answer: This question highlights the universal tension between disclosure compliance and completing franchise sales. The safest compliance practice is to stop franchise sales and redisclose active prospects. This presents problems on the business side. In registration

states, generally the only franchise offering that can be made or sold is the one that is currently registered with the state. The time waiting for approval of the amendment should be considered down time for providing disclosures or signing franchise agreements. Prospects who had deals pending before the renewal or amendment is filed must be redisclosed. California permits the amended offering circular to be sent out while it is pending approval, but a notice has to accompany the disclosure and the prospect must be given the final registered offering circular redlined to show the changes from the version received. Prospects in non-registration states should also be redisclosed. While in registration states there can only be one approved offering circular which may be used to make offers or close sales, there is no hard and fast rule in non-registration states subject only to the Federal Trade Commission Franchise Rule. In the *Staff Report to the Federal Trade Commission and Proposed Revised Trade Regulation Rule*, issued August 25, 2004, the FTC Staff seems to support the side of the franchise sales department, advising that there is no duty to update the disclosure under the FTC Franchise Rule once it is provided, but does note that there are other factors and other laws to be considered, such as the need to avoid making material misrepresentations by failure to provide a material amendment to the disclosure in the offering circular. In non-registration states, the debate over whether to redisclose and start the ten business day waiting period again hinges on whether the amendments are "material".

3. Question: One of the trade magazines just did a great article on our system, including interviews with several of our franchisees who talked about their revenue and profit figures. Can we use this article in our sales packet?

Answer: Any advertising piece, whether prepared internally or reprinted from a trade publication, must be reviewed for obvious or hidden earnings claims or what the FTC calls financial performance representations. The earnings claims will have to be covered over, if possible, or the article cannot be used. Even if the franchisor provides an earnings claim in its offering circular, the article is not likely to agree or provide the information required by Item 19 concerning whether the figures are representative. As a reminder, over half the registration states require franchise sales advertising to be filed before it is used in the state.

4. Question: What offering circular should be used when multiple registration states are involved, for example when the franchisee lives in a different state than the state in which the franchise business will be located? For example, if the franchisee lives in Maryland but the business will be located in Virginia.

Answer: Having the franchisor choose between the potentially applicable states can be dangerous. As a general rule, the prospective franchisee must receive an offering circular appropriate to both registration states if both states claim jurisdiction. Different states have different jurisdictional requirements and you must determine whether the transaction is covered in each one. For example, Virginia does not focus on residency of the prospect, but only claims jurisdiction when the business will be located in Virginia. Maryland, on the other hand, claims coverage of its law when offers are made to residents of the state, even if the business will be located outside of the state.

Under the facts of the example, a Virginia disclosure should be given. Because the prospect lives in Maryland, a Maryland disclosure should be given also. Because of these issues, more and more companies are using a multi-state offering circular containing a basic disclosure with the various state specific addenda to the disclosure and state specific riders to the Franchise Agreement that it will register in all the registration states. The effective dates for each state are shown in an addendum. This would eliminate the need to provide two disclosures, assuming the same version is effective in both states when disclosure is required. Disclosure is only one issue raised when two states have jurisdiction. If one or both states have specific requirements for the franchise agreement, a second issue is which state franchise agreement or franchise agreement rider must be used. For administrative ease by the compliance personnel, all potentially applicable state specific agreements or riders can be used. The addenda and riders should state that they are only effective if the jurisdictional requirements of the state law have been met independently without reference to the addendum or rider, so provisions that are not required under law are not brought into the agreement needlessly.

5. Question: We have developed a system that we can market to existing businesses as an add on to their businesses. We don't want to be a "franchisor" with its attendant disclosure and registration requirements. If we are careful in picking our licensees and we don't expect to constitute more than 20% of their revenues, can we avoid the regulatory requirements under the fractional franchise exemption?

Answer: You have to be careful and analyze the laws of each state where you want to license. While the fractional franchise exemption will help you avoid application of the FTC Franchise Rule if you make sure your prospective licensees satisfy the two year experience requirement and the expectation of not more than twenty percent of their gross sales will result from the licensed business, you may still have to register or file for an exemption or provide an offering circular under state franchise or business opportunity laws. In addition, state relationship statutes may affect your termination rights and other provisions. Most of the approximately thirty states which have franchise or business opportunity laws do not have fractional franchise exemptions. You would have to look for another exemption, such as a registered trademark, experienced franchisor or sophisticated franchisee exemption. Some of these exemptions require a filing and some still require disclosure. There are at least two states which do not appear to have any applicable exemption.

6. Question: Do all franchise owners have to sign a receipt for the offering circular or can one owner sign as representative of all of them?

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Answer: Any individual who will sign the franchise agreement in his or her individual capacity should sign the receipt. This is illustrated by the result in a 2005 case decided under Ontario's *Arthur Wishart Act* where disclosure to a prospect was not considered effective disclosure to his wife, even though she had access to the offering circular at their home. Even though a general partner of a general partnership may bind the partnership, and Illinois law for example expressly permits a general partner to sign for the partnership and the partners, the safer practice is to treat general partners as individuals and require each to sign. For a limited partnership, ideally all the general partners should sign. If there are numerous general partners or other obstacles, this policy may be reconsidered. In the case of a corporation or limited liability company, an authorized officer or member may sign. The FTC Staff has proposed in the revised FTC Franchise Rule issued in August 2004, that an agent, representative or employee, would be able to receive the offering circular and sign the receipt on behalf of the principals involved. The proposed change would permit one individual to sign on behalf of another, or an attorney or accountant to receive the offering circular and sign for their client. It also makes clear that an officer may sign for an entity. If the proposed change becomes effective, there are still evidentiary issues of establishing the agency relationship. The receipt should indicate the representative capacity and the principals and the franchisees should confirm in the franchise agreement or otherwise that they received disclosure through the named representative.

7. Question: We changed auditors this year. What are the requirements for the financial statement presentation?

Answer: The Uniform Franchise Offering Circular Guidelines require that the annual audited financial statements be presented in a comparative format with columns showing at least two years' figures. The balance sheets for the last two fiscal year ends must be included plus statements of operations, of stockholders' equity and of cash flows for the last three fiscal years. The new auditors may include the prior years' financial statement figures audited by the previous firm in the financial statements they issue in order to satisfy the requirement for the comparative columns, but will note in their cover report that the prior years' figures were audited by other auditors. If only two comparative columns are shown in the current year financial statements, the financial statements containing the third year's statement of operations and related reports should be included behind the current year's financial statement. As a matter of courtesy, some clients will request consent of the former auditor to use the old statements again, though consent had been previously obtained when the reports were new.

8. Question: Must a franchisor provide a current offering circular to a franchisee renewing its franchise?

Answer: Under the Federal Trade Commission Franchise Rule, disclosure is not required unless the renewal relationship is under materially different terms and conditions. "Material" is defined as "any fact, circumstance, or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchise business or which has any significant financial impact on a franchisee or prospective franchisee". If the franchisor requires the franchisee to sign the franchisor's then current form of franchise agreement as the renewal agreement, as is often the case, material changes to the franchise agreement may very well have occurred during the intervening years. If the parties are simply amending the term and using the original franchise agreement, an issue comes up whether the offering circular, which describes the current franchise agreement, might be misleading, even though it would update the franchisee with current information on the company. An explanation may be appropriate in this instance to reflect that the franchise agreement described is not the franchise agreement which will be in effect between the parties. Generally, if the franchisor is currently franchising and has an offering circular available, we recommend routinely providing disclosure for a renewal franchise as a means to limit exposure under anti-fraud requirements. This holds true for providing disclosure to existing franchisees for additional locations.

California, Hawaii, Indiana, Maryland, Michigan, New York, North Dakota, Oregon, Rhode Island, and Wisconsin exempt extensions and renewals from the coverage of their disclosure statutes. Generally the exemption requires that there must be no interruption in the operation of the franchised business, and sometimes also no material change in the existing franchise. Even if the state exempts the transaction, the Federal Trade Commission Franchise Rule still applies, and the issue of whether the terms and conditions of the renewal franchise agreement are materially different is key. In future years, when disclosure may be delivered electronically, when the Federal Trade Commission Staff recommendation is adopted in some form, the expense or logistical issues for providing disclosure should be minimized.

9. Question: When we process transfer paperwork, should we prepare the new franchise agreement for the buyer on our then standard form showing the normal full term granted to a new franchisee, with full renewal rights, or should we limit the term to what remained under the seller's franchise agreement?

Answer: To answer this question, you have to look at the governing offering circular and the existing franchise agreement to see how the term under the new franchise agreement is described. If the intent is to limit the

term to only what remained under the franchise agreement, the language should be clear. Usually a buyer will not object if new franchise agreement provides a full term and full renewal rights if the documents indicate only the remaining term would be permitted, but a buyer may object if the expectation was for a full term but a shorter term is granted.

10. Question: We have had inquiries from companies in Canada who want to open our units there. Can we talk to them?

Answer: It is fairly easy to expand into Canada, but doing so will require an investment of time and money to register the trademarks, review tax considerations, set up any new business entities and licensing arrangements, prepare financial statements and adapt the franchise agreement and offering circular. The first step before giving out too much information is to make sure the trademarks will be protected. A trademark search should be conducted followed by filing for trademark registration in Canada. The provinces of Ontario and Alberta require delivery of a disclosure document similar to what we prepare in the United States, but not the same. The tiny province of Prince Edward Island also recently adopted a franchise disclosure law. These provinces also require changes to certain provisions of the franchise agreement. French-speaking Quebec imposes certain language requirements and contract modifications to address Quebec's civil law. Until the Federal Trade Commission Staff's recommendation becomes law and the FTC formally chooses not to exercise its jurisdiction to regulate franchises located outside of the United States, compliance with the FTC Franchise Rule is still an issue. Any state franchise and business opportunity laws where the company is operating also have to be reviewed. As long as there is no event to trigger the disclosure requirement (a first personal meeting under US law currently or signing an agreement or payment of money under both US and Canadian law), it is okay to discuss the possible business arrangements. If the business, supply and distribution arrangements can be worked out, the legal requirements can be addressed as well.

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