



# FRANCHISE SALES COMPLIANCE



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- Federal Law
  - Presale Disclosures
  - Advance Delivery of Franchise Contracts
  - Financial Performance Representations
- State Franchise Sales Laws
- Business Opportunity Laws



# Federal Law – What Transactions Are Covered

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- Trademark license
- Significant control or assistance
  - Significant control includes site approval, site design or appearance requirements, hours of operation, production techniques; accounting practices, personnel policies; promotional campaigns requiring franchisee participation or financial contribution; restrictions on customers; and locale or area of operation
  - Significant assistance include formal sales, repair, or business training program, establishing accounting systems; furnishing management, marketing or personnel advice; selecting site locations; furnishing system wide networks and website; and furnishing a detailed operating manual
- Payment element

# Federal Law – Exemptions and Exclusions

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- No application to sale of franchises outside of the U.S.
- Minimum payment
- Leased departments
- Fractional franchise
- Large franchise investment - \$1 Million
- Large franchisee exemption - \$5 Million
- Oral agreements
- Petroleum Marketing Practices Act
- Insider's exemption



# Federal Law – What the Law Requires

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- Presale disclosures
- Advance delivery of contracts
- Restrictions on Franchise Performance Representations



# Federal Law – Form of Disclosures

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- Must be in writing – “writing” broadly defined to include type set, word processed, handwritten documents, as well as documents transmitted as electronic information on a computer disk, CD-ROM, an email, or in web pages posted on the Internet
- Electronic disclosure permitted – but no electronic features such as audio, video, pop-ups, or external links
- Navigational features, such as scroll bars, search functions and internal links okay if they assist in reviewing the disclosure document



# Federal Law – Providing Disclosures

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- Must be furnished 14 calendar days before a prospective franchisee signs a binding agreement or pays consideration for the franchise
- Must be given earlier in the sales process if requested by a prospective franchisee
- Disclosure to a prospective franchisee's agent, such as an attorney, satisfies disclosure obligation
- Disclosures to an officer of a corporate franchisee satisfies disclosure obligation
- Proving receipt of electronic disclosures



# Federal Law – Advance Delivery of Contracts

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- Prospective franchisees have the right to review franchise contracts 7 days before signing
- If the franchisor “unilaterally and materially amends” the franchise agreement, must provide to a prospective franchisee 7 days before signing or payment
  - Does not apply to negotiated changes
  - Does not apply when changes are non-substantive, *i.e.*, “fill-in-the-blank” provisions, such as franchisee’s name and address
  - Substantive changes include inserting a specific radius or geographic area comprising a protected territory, the actual number of stores to be opened under a development agreement, the specific interest rate to be paid by a franchisee or other contractual terms that were not previously disclosed in the disclosure document



# Financial Performance Representations

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- Franchisor may not “disseminate any financial performance representations **to prospective franchisees**” unless:
  - FPR has a reasonable basis when made
  - Franchisor has written substantiation when made
  - FPR is included in Item 19 of the Franchisor’s disclosure document
- Includes “media claims”
  - All forms of advertising, including radio, TV, magazines, newspapers, and billboards
  - Electronic advertising, including web site advertising
  - “Spam” solicitations

# Financial Performance Representations

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- *“Ordinarily, company statements in speeches, press releases, and the like will not be considered ‘general media representations,’ unless they are specifically directed at members of the public interested in purchasing a franchise.”*
- *“However, where a franchisor utilizes financial performance information disseminated or intended to be disseminated to the public generally in its franchise promotional materials, and includes in its franchise promotional materials a reference to general financial information ... such information will be deemed general media financial performance representations.”*

» *Federal Trade Commission, Franchise Rule Compliance Guide*



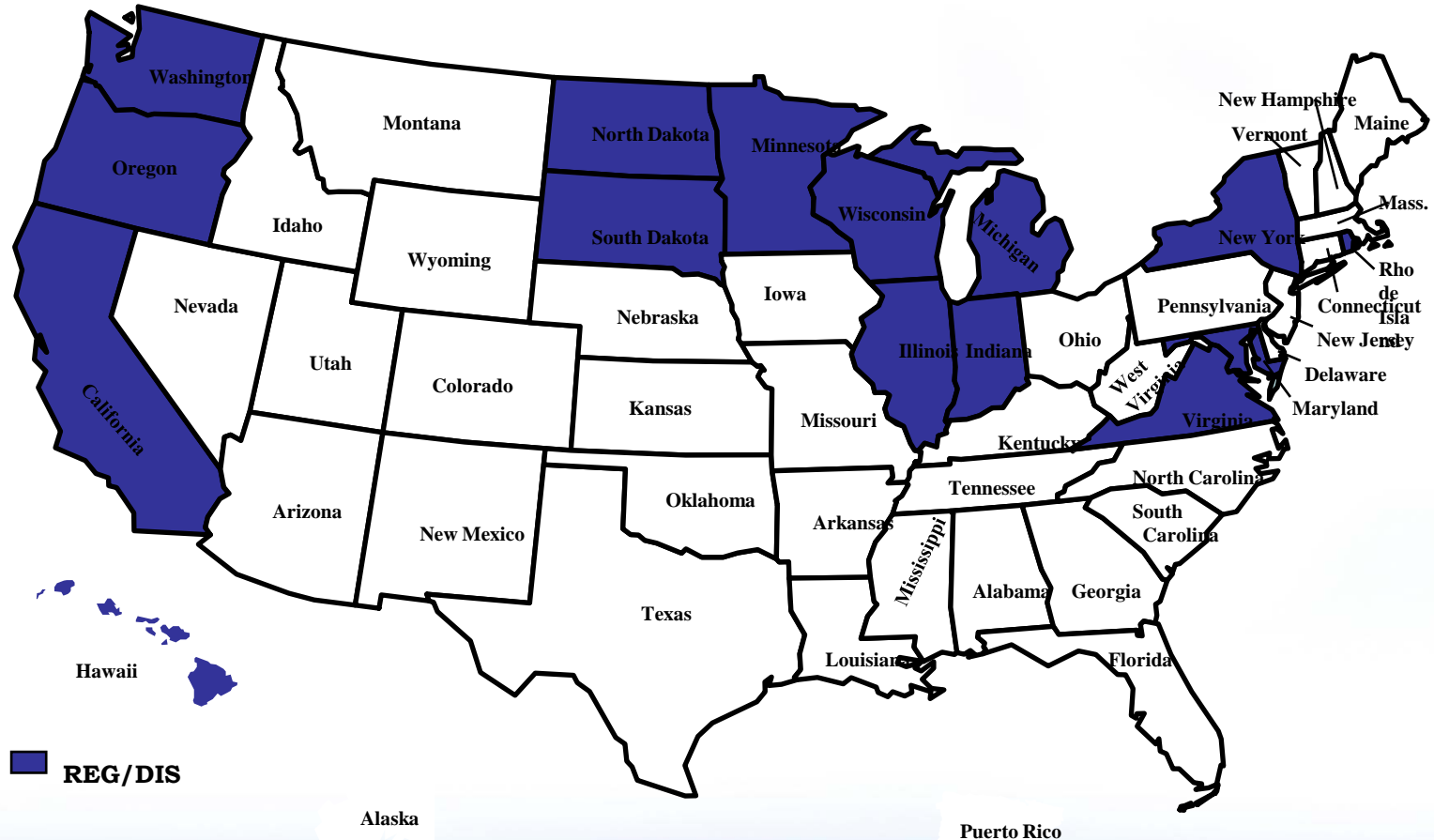
# Financial Performance Representations

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- Franchisor may disclose only the actual operating results for a specific outlet being offered for sale without complying with these requirements, if the information is given only to potential buyers of that outlet



# State Franchise Sales Laws



# State Franchise Sales Laws

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- Potentially apply when:
  - Franchisee resides or is domiciled in state
  - Franchise business will be operated in state
  - Offer originates from state
  - Offer is directed to or accepted in state



# State Franchise Sales Laws

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- Indiana, Michigan, and South Dakota
  - Annual notice of franchise offering
  - Effective upon receipt by the state
  - No amendments required (but South Dakota requires quarterly disclosure document updates and notification if the franchisor's auditor expresses "going concern" issue)
- Wisconsin
  - Annual filing
  - Effective upon receipt by the state
  - Must file amendment within 30 days after happening of "material event"
- California, Hawaii, Illinois, Minnesota, New York, North Dakota, Rhode Island, Virginia and Washington
  - Annual renewal or annual report
  - Effective when approved by state examiner
  - Must file amendment in the event of material change



# State Franchise Sales Laws

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- Maryland, New York and Rhode Island – “first personal meeting” disclosure requirement
- California – Notice of Negotiated Change if franchise sold on terms different from the terms of the registered offer
- Maryland – Quarterly Sales Report
- New York – Annual Sales Report



# State Franchise Sales Laws

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- Franchise Brokers and Lead Referral Networks
  - No Item 2 disclosures required, but State Effective Dates page must state

**We use the services of one or more FRANCHISE BROKERS or referral sources to assist us in selling our franchise. A franchise broker or referral source represents us, not you. We pay this person a fee for selling our franchise or referring you to us. You should be sure to do your own investigation of the franchise.**
  - Several states require franchise seller's disclosure form for each individual participating in the sale of franchises
  - New York requires filing of Sales Agent Disclosure Form by every person acting as a "franchise sales agent" (i.e., a person other than the franchisor, subfranchisor, or their employees who directly or indirectly engages in the offer or sale of any franchise on behalf of another)
  - Washington requires registration of "franchise brokers" (i.e., a person other than the franchisor, subfranchisor, or their officers, directors or employees who directly or indirectly engages in the business of the offer or sale of franchises)





# State Franchise Sales Laws

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- Franchise Brokers and Lead Referral Networks
  - May have disclosure obligations in states with “first personal meeting” disclosure requirements



# State Franchise Sales Laws

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- What to do while a renewal application or amendment is pending
  - Best practice to stop all sales and redisclose prospects in the sales pipeline when new disclosure document approved for use
  - Illinois – Must redisclose all franchise prospects (even if the prospect previously received disclosures) and wait 14 calendar days before closing



# State Franchise Sales Laws

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- What to do while a renewal application or amendment is pending
  - Generally, neither the FTC nor any state (other than Illinois) requires delivery of updated disclosures or imposes additional waiting periods
  - Generally, the updated or amended disclosure document may not be used to satisfy disclosure obligations until the renewal application or amendment becomes effective
  - Generally, so long as no lapse in registration, a franchise sale may still close based on the previously registered disclosure document
  - Failure to provide updated disclosures potentially violate anti-fraud provisions of several state franchise laws



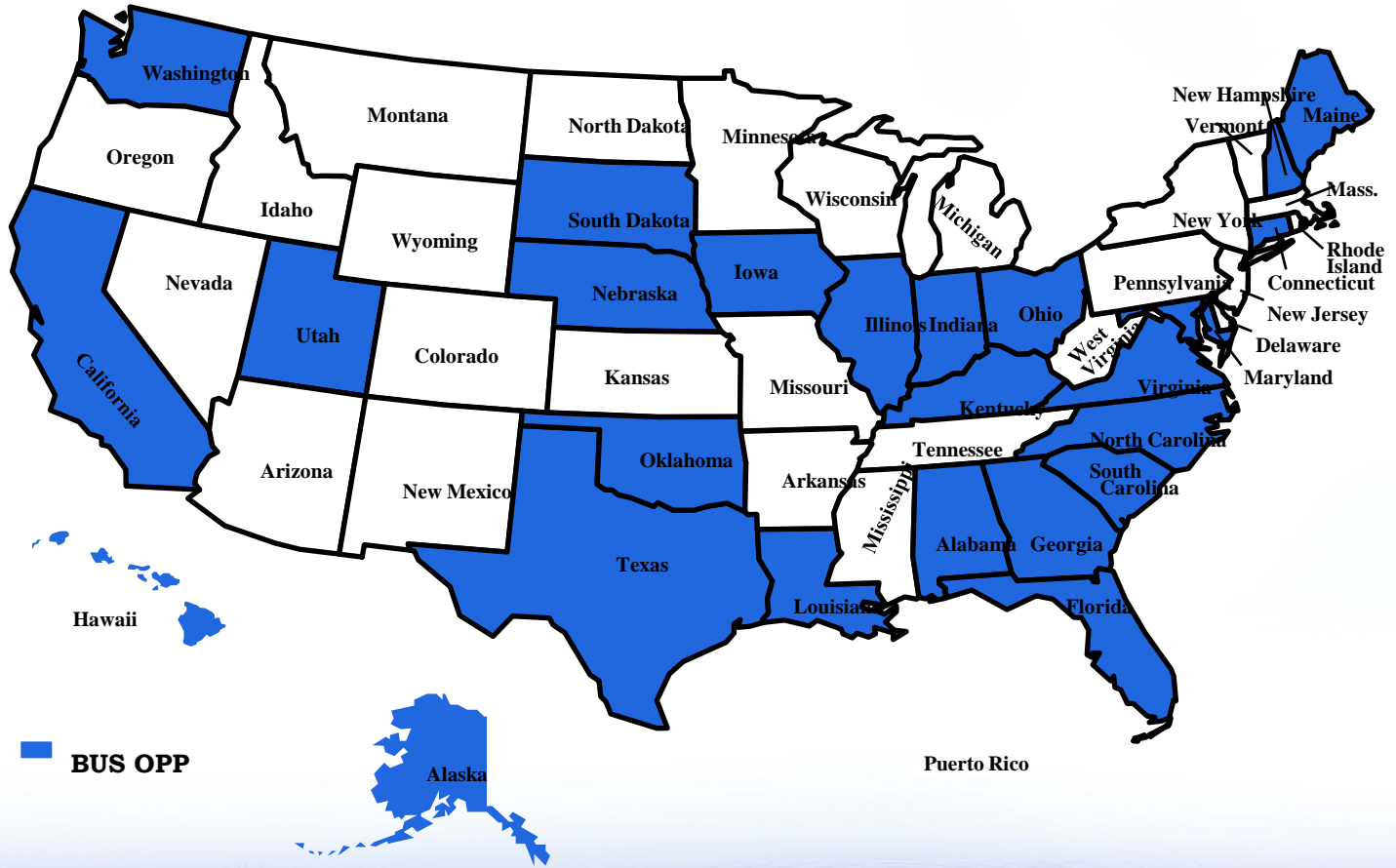
# State Franchise Sales Laws

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- Sales literature
  - California, Maryland, Minnesota, New York, North Dakota, Rhode Island and Washington require advance filing of sales literature
  - Sales literature used in New York must reflect special language
  - Sales literature used in California, Illinois, Maryland, Minnesota, and Washington is subject to any or all of the following
    - May not state or imply that purchase of a franchise is a safe investment or that failure, loss or default is impossible or unlikely, or that earnings or profits are assured
    - Restrictions against financial performance representations
    - If reference to the registration of the franchise, additional disclosures are required
    - If reflects endorsement by public figure, compensation or benefits promised to the public figure must be disclosed
    - If reference to tax benefits or legal opinion, the name of counsel must be disclosed



# Business Opportunity Laws



# Business Opportunity Laws

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- Apply to the sale of franchises
- Exemptions may apply if
  - Franchisor has a registered trademark
  - Proper filing is made
  - Franchisor complies with federal disclosure requirements



# Remedies for Violation

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- Consequences of Violations
  - Investigation
  - Cease and Desist Orders
  - Rescission Rights
  - Civil Lawsuits
- Limitation of liability through contractual representation, merger and integration clauses, and closing questionnaires



# Franchise Sales Compliance

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## *QUESTIONS?*

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