



Regulation of Franchise Sales Overview

Federal Franchise Disclosure Regulation

The Federal Trade Commission (FTC) issued “Disclosure Requirements and Prohibitions Concerning Franchising,” 16 C.F.R. Part 436 (FTC Rule), in 1979 and substantially revised the Rule in 2007. The FTC Rule requires franchisors to provide a prospective franchisee a copy of the franchisor’s current franchise disclosure document (FDD) prior to the sale of a franchise. (The FDD delivery requirements under federal and state law are detailed below.) The FTC Rule applies throughout the United States and its territories and possessions, including Puerto Rico.

State Franchise Registration and Disclosure Regulation

The 15 states identified in the table below likewise require franchisors to provide pre-sale disclosures to a prospective franchisee generally if: (1) the offer or sale of a franchise is made in the state; (2) the offer is directed within the state; (3) the franchised business will be located in the state; and/or (4) the prospective franchisee is a resident of, or domiciled in, the state. As detailed below, 14 of these states require franchisors to register the FDD or otherwise make a formal filing with the state before the franchisor may offer or sell a franchise in the state, and in 10 of these states, franchise examiners review the FDD to ensure its compliance with the FTC Rule and applicable state law.

State	Registration of FDD or Other Formal Filing Required?	FDD Review by State Franchise Examiner?
California	Yes	Yes
Hawaii	Yes	Yes
Illinois	Yes	Yes

State	Registration of FDD or Other Formal Filing Required?	FDD Review by State Franchise Examiner?
Indiana	Yes	No*
Maryland	Yes	Yes
Michigan	Yes	No*
Minnesota	Yes	Yes
New York	Yes	Yes
North Dakota	Yes	Yes
Oregon	No	No
Rhode Island	Yes	Yes
South Dakota	Yes	No*
Virginia	Yes	Yes
Washington	Yes	Yes
Wisconsin	Yes	No*

*Annual notice filing, including a copy of the FDD (except for Michigan), only.

State Business Opportunity Regulation

In addition to the registration and disclosure laws described above, 26 states (Alaska, Arizona, California, Connecticut, Florida, Georgia, Illinois, Indiana, Iowa, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, South Dakota, Texas, Utah, Virginia, and Washington) have enacted “business opportunity” laws that do not specifically regulate franchising but, rather, regulate the sale of opportunities to engage in new business ventures (which, in many cases, include franchises). In a number of states, franchise offerings are expressly excluded from the scope of the applicable business opportunity law if

the franchisor complies with the FTC Rule or applicable state franchise registration and disclosure laws and/ or if the franchisor is licensing a federally registered or state-registered trademark. Franchisors must file an annual exemption notice in Florida and Utah and a one-time exemption notice in Kentucky, Nebraska, and Texas, however, to qualify for the applicable business opportunity exemption in those states.

Relationship Between Federal and State Regulation

The FTC Rule does not prohibit states from prescribing additional disclosures for the FDD or mandating other requirements. In fact, since its promulgation of the FTC Rule in 1979, the FTC has made clear that it does not intend to preempt the franchise laws of any state or local government except to the extent that they are inconsistent with the FTC Rule. A law is not inconsistent with the FTC Rule if it affords prospective franchisees equal or greater protection, such as registration of FDDs, more extensive disclosures, and, as discussed below, a longer FDD delivery period. Consequently, franchisors must comply with both the FTC Rule and more stringent state franchise laws.

Other Pre-Sale Requirements

Advertising Filing Requirements

Several states require franchisors to file all advertising for franchises with the state within a prescribed time period prior to use. Such advertising is generally deemed approved unless the state objects within a specified time period. These states generally define a franchise advertisement as any published communication directed to a prospective franchisee that discusses the sale of a franchise. These states include:

- California
- Maryland
- Minnesota
- New York
- North Dakota
- Washington

Advertising that appears in a newspaper (or other publication of general, regular, and paid circulation) that has had two-thirds of its circulation outside the state during the past 12 months does not have to be filed in the state. Each state likewise has a limited exemption for Internet advertising.

Most of these states, as well as others, also restrict the types of claims that can be made in such advertisements. These restrictions include prohibitions on referring to the franchise as a safe investment or implying that state registration of the FDD constitutes state approval, as well as a requirement that, when using a public figure in franchise

advertising, the franchisor must disclose whether the public figure is being compensated.

Franchise Seller Disclosure Forms

California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, and Washington also require franchisors to file a Franchise Seller Disclosure Form for each person who may be engaged in soliciting, offering or selling franchises on behalf of the franchisor. A form must be submitted for the franchisor's own employees, for the employees of the franchisor's parent(s) or affiliates, and for any independent third party (i.e., franchise broker) that may be providing sales services on behalf of the franchisor in the state. New York and Washington also require the registration of franchise brokers.

FDD Delivery Requirements/Completed Agreement Hold Times

The FTC Rule requires franchisors to provide a prospective franchisee a copy of the franchisor's current FDD at least 14 calendar days before the prospective franchisee signs a binding agreement with, or makes any payment to, the franchisor or an affiliate in connection with the proposed franchise sale (or earlier if the franchisee reasonably requests). Michigan and New York, however, currently require that disclosure be made at a time that may be earlier than that required by the FTC Rule. Specifically, Michigan requires franchisors to provide the FDD at least 10 business days before the earlier of the execution of any binding franchise or other agreement or payment of any consideration. New York requires franchisors to provide the FDD at the earlier of the first personal meeting or 10 business days before the execution of the franchise or other agreement or payment of any consideration that relates to the franchise relationship.

While all agreements regarding the franchise offering are required to be attached to the FDD, a franchisor is generally not required to furnish a prospective franchisee with a copy of the completed franchise agreement in advance of the date of the execution. If, however, the franchisor unilaterally and materially alters the terms of any franchise agreement attached to the FDD previously provided to the prospective franchisee, the franchisor must give the prospective franchisee a copy of the revised agreement at least seven calendar days before execution. The mandatory seven-calendar-day review period does not apply where the only differences between the standard agreement and the completed agreement are non-substantive "fill-in-the-blank" provisions, such as the date, name, and address of the franchisee. The addition of substantive terms, such as a specific radius or geographical area comprising a protective territory, the actual number of outlets to be opened pursuant

to a development agreement, the specific interest rate payable by the franchisee, or other contractual terms that were not previously disclosed in the FDD or its attachments, will trigger the seven-calendar-day review period.

These timing requirements may not be waived.

Updating the FDD

Under the FTC Rule, the FDD must be updated annually within 120 days after the franchisor's fiscal year end. (Notably, the "expiration date" of the FDD in certain registration states varies from the FTC Rule. In those states, *generally*, the effectiveness of the FDD in the applicable state is tied to the anniversary of the FDD filing date or the calendar year.) If a "material" change to any information in the FDD occurs prior to the "expiration" of the FDD, the franchisor must amend the FDD. A "material" change is anything significant that would influence a prospective franchisee in making his investment decision. As a practical matter, common circumstances under which the FDD should be updated include significant changes in management personnel, mergers and acquisitions involving the franchisor, certain types of new litigation, changes to the agreements, fees or programs, significant negative changes in the number of existing franchisees (including the number of unilateral terminations by franchisees), and adverse changes in the franchisor's financial status.

Liability for Non-Disclosure, Failure to Register, and Misrepresentation

Under the FTC Rule, the FTC has the authority to seek civil penalties against a franchisor for violations of the FTC Rule. Each of the pre-sale disclosure states has similar authority to seek penalties for violations of its requirements. Violations may include offering or selling an unregistered franchise, failing to timely provide the FDD to a prospective franchisee, or misrepresentation. In addition, officers of the franchisor may have personal liability if they had knowledge of or participated in the violations.

Private individuals cannot sue a franchisor for a violation of the FTC Rule. Most of the pre-sale disclosure states, however, grant a private right of action for violation of the state statute and have remedies that typically include damages, rescission of the contract, and attorneys' fees.

What Is a Franchise?

Although the definition varies by jurisdiction, as a general rule, a business will be considered a franchise if it meets the following three criteria:

- The franchisee's business is identified or substantially associated with the franchisor's trademark.

- The franchisor exerts sufficient control over the franchisee's business or there is interdependence between the franchisee's business and the franchisor's system. There are three different tests used to determine whether the franchisor exerts sufficient control:

- First, the FTC Rule uses the "significant control" or "significant assistance" test, which is applicable in the majority of the states. This test focuses on the franchisor's level of control over, or assistance with, the franchisee's entire business.
- Second, under the "marketing plan" test, which is used by several states, the control analysis centers on whether the franchisor has prescribed a marketing plan that the franchisee must follow.
- Third, under the "community of interest" test, which is used in a smaller number of states, the focus is on whether there is a sufficient level of interdependence between the franchisee and the franchisor.

- The franchisee is obligated to pay money to the franchisor or its affiliates for the right to engage in the business. Almost any monies paid to the franchisor or its affiliates can satisfy this element, except for the purchase of inventory at bona fide wholesale prices.

Some jurisdictions exclude from registration and disclosure certain business relationships that meet the definition of a franchise. Examples of excluded relationships are general partnerships, employment relationships, fractional franchises (generally, franchisee has experience in the franchised business, and the new franchised business will account for less than 20% of the franchisee's total sales), and certain large investments or sophisticated franchisees.

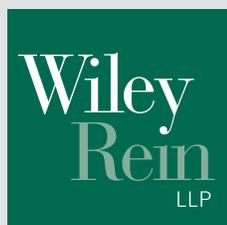
Additionally, a number of states require certain franchisors to provide disclosure but do not require registration. The most common registration exemption is for a franchisor whose net worth exceeds a certain level (\$5 million, \$10 million, or \$15 million, depending on the state) and who is experienced in the franchised business.

Since the definition of a "franchise" and the applicable exclusions and exemptions vary, a business relationship may be considered a franchise in some jurisdictions but not in other jurisdictions. ■

FRANCHISE *Services*

Wiley Rein LLP represents franchisors on matters for which they require expert legal services. We can:

- Determine whether your business concept is a franchise. If it is a franchise, but you would prefer to avoid the registration disclosure requirements, we can help you to modify the business concept to avoid coverage by the franchise laws, if possible, or take advantage of applicable exclusions.
- Work with you to develop franchise and related agreements that will permit the growth of your concept while allowing you to maintain control.
- Seek federal registrations for your trademarks and provide assistance in maintaining and protecting those marks.
- Prepare the Franchise Disclosure Document (FDD) and provide FDD compliance training to your franchise sales and franchise administration teams.
- Prepare and file all franchise registrations, exemptions, amendments, and renewals in all applicable states.
- If you are a U.S. franchisor, assist you in developing your franchise concept abroad; if you are a foreign franchisor, assist you in bringing your franchise concept to the U.S.
- Help you understand your contractual rights and obligations and the statutory restrictions that apply to the franchise relationship, including transfers and contract renewals.
- Represent you in any proceedings brought by federal or state franchise regulators.
- Guide you in terminating the relationship with a franchisee without violating statutory restrictions.
- Represent you in litigation or arbitration proceedings with a franchisee.



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