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Basic Legal Framework for Franchising

The following summary highlights basic legal aspects that business owners, officers, directors and other persons involved in franchising should consider when growing their business through franchising.

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The summary below is not intended to be a comprehensive statement of the franchise laws in the United States, and individual issues must be addressed on a case-by-case basis, but the information below should be helpful as a reference for officers, directors and others persons who are involved in franchising and the process of selling franchises.

Sale of Franchises – Generally

The sale of any franchise in the United States is governed by laws at both the federal and state levels. The Federal Trade Commission (FTC) has been granted broad power to regulate the sale of franchises in all 50 states and requires anyone selling a franchise (franchisor) to provide a specific Franchise Disclosure Document (FDD) to any prospect (franchisee) to whom the franchisor, or anyone acting on the franchisor's behalf, attempts to sell a franchise. Under the FTC rule, the FDD must be provided to the franchisee at least 14 days before the franchisee signs any agreement or pays any money to the franchisor. Before attempting to sell a franchise anywhere in the United States, the franchisor must properly prepare the FDD or else be subject to penalties imposed by the FTC. The FDD must contain 23 specific disclosure items which include detailed descriptions of fees, royalties, estimated costs, required purchases, territory granted, other rights granted and franchisor support.

In addition to the federal regulation by the FTC, several states have franchise laws that impose additional disclosure requirements on franchisors and require franchisors to register with the applicable state regulator before selling franchises in that state. If the franchisor fails to comply, the franchisor can be subject to penalties and franchisees may have the right to sue the franchisor for violating state law depending on the laws of the state.

Misconceptions often exist about when these franchise laws apply because many unfamiliar with franchising believe that franchise laws do not apply to grants of a license, distribution right or other similar types of

arrangements that are not called a franchise. However, the name given to a particular relationship or arrangement does not determine whether it will be considered a franchise for purposes of the franchise laws. If all of the following elements are present, the relationship or arrangement will generally be regulated as a franchise under these laws:

- Granting another person the right to offer and sell goods or services;
- Allowing another person to use the franchisor's brand identification such as a trademark, service mark, logo or trade name;
- Exercising significant control over, or providing significant assistance to, another person in the operation of the business; and
- Receiving payment from another person.

State Registration

Depending on the specific laws of a particular state, the franchise laws of that state may apply to a franchise sale by the franchisor based on one or more of the following:

- The prospect is a resident of the state;
- The offer originates from the state;
- The offer is received in the state;
- Meetings between the franchisor or its representatives and the prospect occur in the state;
- The offer is accepted in the state;
- The business being franchised will be operated in the state; or
- The territory of the franchise being granted is entirely or partially in the state.

If a particular state's franchise laws apply to a franchise sale, a franchisor must register with the applicable state regulator in the following states: California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. In addition to these registration states, Florida, Kentucky, Nebraska, Texas and Utah require a franchisor to file notice with the applicable state authority. Registration or filing notice is generally required before the franchisor makes any contact with the prospect other than to obtain the prospect's name and address. Each registration state also generally requires that the franchisor's FDD comply with state-specific disclosure requirements before it will approve the franchisor's registration. If the franchisor qualifies, there are exemptions available from the registration and disclosure requirements.

The initial franchise registration process can take anywhere from four weeks to six months. The registration application generally includes payment of filing fees (fees vary in each state) and submission of the franchisor's FDD and other related documents. The state regulators review (1) the FDD for compliance with the applicable franchise laws, (2) the proposed agreements and (3) the franchisor's financial statements, and focus on the franchisor's overall financial condition. Often, a franchisor will receive at

least one comment letter from a state regulator that describes deficiencies in the application or request additional information, clarification or changes to certain items in the FDD or certain provisions of the franchise agreement or related agreements. When all deficiencies have been resolved, the state regulator will approve the registration and the franchisor can begin selling franchises in that state.

The registration states also require that each franchisor submit a Franchise Seller Disclosure form for each person who may be engaged in soliciting, offering or selling franchises on behalf of the franchisor. Generally, this form is submitted for the franchisor's own employees, for the employees of its parents and affiliates, and for any independent third party (such as a broker) who sells franchises on the franchisor's behalf.

Sales Process – Specific Requirements

Under the federal rules, the FDD, including audited financial statements and all agreements relating to the purchase of the franchise, must be delivered to prospects at least 14 calendar days before the prospect pays any money to the franchisor or signs a binding agreement.

Most of the registration states have adopted this 14-day waiting period, but a few states have timing requirements that are slightly different.¹ To ensure the applicable period has been satisfied, each prospect should sign and date the FDD receipt in duplicate, with one copy of the receipt being retained by the franchisor and placed in a separate file for each prospect so that the franchisor has evidence of its compliance with the applicable waiting period requirement. Many state laws allow a franchisee to rescind the franchise agreement if there is a violation of the applicable waiting period.

In addition to the applicable waiting period, if there are any changes to the franchise agreement, or if material blank spaces must be completed, the prospect must generally receive a completed, final franchise agreement at least seven days prior to payment of any consideration or the execution of the franchise agreement.

During the sales process, it is imperative that the franchisor and anyone selling franchises on the franchisor's behalf do not make any financial performance representation to any prospect unless the franchisor has disclosed the same financial information in Item 19 of its FDD. For purposes of federal law, a financial performance representation is any representation, including oral, written or visual, made to a prospect that states expressly or by implication, a specific level or range of actual or potential sales, income, gross profits or net profits and specifically includes charts, tables and mathematical calculations that show possible results based on variables. Pure cost information is excluded, but cost information stated as percentage of sales or in another manner that allows for the determination of any of the prohibited items

¹ New York and Rhode Island require the disclosure document be delivered at the earlier of the first personal meeting or 10 business days before the execution of any binding franchise or other agreement or the payment of any consideration, whichever occurs first. Michigan requires that the disclosure document be delivered at least 10 business days before the execution of any binding franchise or other agreement or the payment of any consideration, whichever occurs first. Iowa requires the disclosure document be delivered at the earlier of the first personal meeting or 14 days before execution of the franchise agreement or other agreement or the payment of any consideration that relates to the franchise relationship.

in the definition above is a financial performance representation. Prospects can be directed to existing franchisees who can talk about the financial performance of the locations or territories operated by the franchisee.

In addition to the specific restrictions on financial performance representations, the franchisor (and anyone selling franchises on the franchisor's behalf) cannot make any representation (written or oral) to any prospect that is inconsistent with the FDD or any other document filed with a state franchise regulator. A material inconsistent representation may subject the franchisor and its officers and directors to civil and criminal liability.

Annual Updates and Material Changes

The FTC rule requires revision of the FDD annually within 120 days after the close of the franchisor's fiscal year, or "on at least a quarterly basis" after a material change occurs in the information disclosed. California and Hawaii have slightly different timing requirements for the annual update.

In addition to the annual renewal requirements, a franchisor must update its FDD upon the occurrence of a material change which is generally 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" and includes:

- Termination or failure to renew by substantial portion of franchisees;
- Significant change in the franchisor's management team, such as new CEO, or changes of other keyofficers;
- An adverse change in the franchisor's financial condition;
- A change fee or other significant changes in the franchise offering or franchise system; and
- Acquisitions of competitive concepts or offerings of competing franchises.

In most of the registration states, a material change requires a franchisor to stop all sales activities pending approval of an amendment to the franchisor's registration. Some states allow for the continued offer of franchises pending the effectiveness of an amendment. As a best practice, most franchisors cease selling franchises upon the occurrence of a material change and redisclose all franchise prospects with an updated FDD incorporating all material changes.

Marketing Materials

In addition to the registration requirements described above, seven registration states require advertising and marketing materials for the sale of franchises to be filed with the state regulator before being used in that state. In California, the regulator must also approve the advertising and marketing materials prior to use and generally rejects any advertisement containing words like "success" or "safe investment" or suggesting that failure is unlikely.

In addition, several states require a franchisor to file an Affidavit for Exemption for Internet Advertising, which states that the franchisor will comply with applicable laws when using internet advertisements. In addition to the placement of traditional written advertisements, the requirements also apply to brochures, direct mail letters and reply cards placed in existing locations.

Document Retention

Franchisors should control the delivery of FDDs to prospects and should develop filing systems which include a separate file for each prospect that receives the FDD. Each file should include: (1) a copy of the FDD provided to the prospect, (2) copies of all correspondence, (3) an executed and dated receipt from the prospect to demonstrate compliance with the disclosure requirements, and (4) a copy of the fully executed franchise agreement (and any addenda or amendments to the franchise agreement and any other related agreements) for each prospect who becomes a franchisee. Franchisors should also maintain separate files for their applications and registrations in each registration state.

Relationship Laws

In addition to the disclosure and registration requirements in various states, many states have relationship laws that apply to the termination or renewal of a franchisee and often require a franchisor to give notice, have “good cause” or both before ending a franchise relationship. These laws can also impose obligations upon franchisors such as the obligation upon termination to buy back excess inventory from the franchisee. A few states also have laws that prohibit the franchisor from discriminating between similarly situated franchisees.

Other Laws

Finally, in addition to the laws and legal principles set forth above that specifically apply to franchising, there are a number of other laws and legal principles that can affect franchise systems, such as the common law principles of good faith and fair dealing in relationships between franchisors and franchisees and vicarious liability of franchisors to third parties for the acts of franchisees and their employees as well as other trademark and antitrust laws.

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