

International Franchise Association
51st Annual Legal Symposium
May 6-8, 2018
Washington, DC

A Practical Guide to Managing Issues Faced by Start-Up and Small Franchisors

Cheryl Lucente
Bloomin' Brands, Inc.
Tampa, Florida

Sawan Patel
Larkin Hoffman
Minneapolis, Minnesota

Leslie Pujo
Plave Koch, PLC
Reston, Virginia

A PRACTICAL GUIDE TO MANAGING ISSUES FACED BY SMALLER AND/OR STARTUP FRANCHISORS

Franchisors of startup or small, emerging brands face unique challenges and opportunities.¹ From structuring the initial offering—when the franchisor has no franchisees² and perhaps just a handful of corporate-owned locations—to making the first sale and beyond, starting and growing a franchise system typically requires business and legal expertise that may differ significantly from the skills required to sell products or services to end customers. Indeed, a new franchisor must consider that when it launches a franchise offering, it will no longer just sell cupcakes or yoga sessions to consumers, but also will offer franchise opportunities to entrepreneurs who wish to purchase the right to operate a business using the franchisor’s brand and system. How newer franchisors adapt to the new business offering and develop procedures to attract, on-board, and manage their initial franchisees is critical to the long-term growth and health of the franchise system.

This paper highlights some key challenges and opportunities faced by startup and small franchisors. The paper does not attempt to address all of the challenges that these franchisors face. Nor does it take into consideration the entire life cycle of a franchise system.³ Instead, the goal of this paper is to provide startup and smaller franchisors with a practical guide to managing some of the key issues that they are likely to encounter as they develop and launch their franchise system, including issues related to franchise system structure and the sales program, estimated initial investment disclosures and

¹ For purposes of this paper, we define “startup” franchisors as those with 5 years of franchising experience or less, and “smaller” franchisors as those with 25 or fewer outlets.

² The issue of whether a startup franchisor has existing non-franchised “licensees” or other purported non-franchised arrangements that might be viewed as franchises is beyond the scope of this paper. See Paul Fransway, *Traversing the Minefield: Recent Developments Relating to Accidental Franchises*, 37 *FRANCHISE L.J.* 2, 217 (2017) and Kenneth R. Costello, Beata Krakow & Kristy Zastrow, *From License Agreement to Regulated Relationships: The Accidental Franchise*, ABA 32nd Annual Forum on Franchising (2009) (for detailed discussions of “accidental franchises”); see also Ann Hurwitz & David W. Oppenheim, *You Don’t Want to be a Franchise? – Structuring Business Systems Not to Qualify as Franchises*, ABA 34th Annual Forum on Franchising (2011) (discussing licenses, distributorships, joint ventures and sales representative programs as alternatives to franchising).

³ For more information on the life cycle of a startup or small franchisor—from conception to established brand—see, e.g., Debra A. Harrison & David W. Koch, *The Evolving Franchise System: How to Guide an Emerging System from “Baby Steps” to a “Grown-Up” System*, IFA 43rd Annual Legal Symposium (2010).

financial performance representations, franchise registration requirements and strategies, and ongoing management of franchise relationships.⁴

1. Structuring the Franchise System and Developing the Sales Programs

Similar to building a home, startup and smaller franchisors need a solid foundation upon which to build their franchise system. Before “pouring the footers” of the franchise system foundation, the new franchisor must survey: the competitive conditions of the franchisor’s industry; the franchisor’s own experience, skills, and resources; and the viability of the franchisor’s business as a franchise concept.⁵ To create a sustainable and thriving franchise system, it is essential that the new (and smaller) franchisor build on this foundation carefully. Good decisions in the initial stages of franchising can create competitive advantages that will lead to network growth and the mutual success of the franchisor and its franchises; poor decisions can curtail initial growth and cause chronic problems to the franchisor’s ability to move the system forward and possibly lead to the demise of the franchise system.

Keeping this in mind, the startup franchisor can turn to two of the most important startup issues: (1) developing the structure and terms of its franchise offering; and (2) creating franchise sales compliance programs and systems.

a. Determining the Structure and Terms of the Franchise System

In developing the structure and terms of the franchise system and offering, the startup franchisor likely will turn to outside advisors to help understand a variety of factors, including the competitive landscape and the legal issues implicated by franchising.

(1) Business and Legal Advisors

Recognizing that launching a new franchise system requires new and different skills, franchisors typically (but not always) retain third-party business and legal advisors to assist with the structuring, documentation, and eventual registration of a franchise offering. For example, franchise consultants may prepare a detailed business plan and assist with the development of the franchise system’s structure, including the type of franchise offered (*e.g.*, single unit, area development, and/or area representatives); territorial issues; initial and ongoing support; fees and charges; supply-chain issues; initial

⁴ Since the primary purpose of this paper is to provide a practical guide to smaller and startup franchisors, this paper includes several checklists, practice pointers, and summary tables. In addition, Appendices A through F contain several checklists, templates, and summary charts, which are designed to aid franchisors in managing the issues addressed in the narrative of this paper.

⁵ See *e.g.*, Harrison & Koch, *supra* note 3, at 2-3 (discussing issues that potential franchisors should consider before launching a new franchise system, including whether the concept is “franchiseable”).

and ongoing fees; field support and quality assurance; and transfer and renewal options.⁶ A franchise consultant also may prepare the franchisor's operations manual ("Operations Manual").⁷ Experienced franchise business consultants can provide a wealth of information to a new franchisor to use in structuring the franchise system, especially if the consultant has previous experience in the franchisor's industry.

Franchise attorneys generally use questionnaires to prepare franchise disclosure documents ("FDDs"), franchise agreements and ancillary agreements, and may also review any business plans and Operations Manuals prepared by the franchisee or its consultants. The franchise attorney will most often handle registration of the franchise offering where required,⁸ and provide legal advice on other issues (such as trademark, corporate structure, industry-specific regulations, and others) as necessary. As the system grows, franchise attorneys can assist the franchisor in managing franchise relationship issues, such as defaults, terminations, transfers, and renewals. Franchisor attorneys with extensive experience drafting and reviewing FDDs and assisting with ongoing operational issues may be able to help startup and smaller franchisors avoid common legal issues. For example, experienced attorneys may be able to point out possible legal consequences of proposed terms, such as rights of first refusal, covenants against competition, franchisor purchase options, marketing requirements, and others. Experienced franchise attorneys can also ensure that the franchisor reserves sufficient rights in areas such as branding, technology, and approved suppliers so that the franchisor can continue changing and growing the system for years to come.

A franchise relationship is typically a long-term one with new franchisees often signing 5- to 20-year franchise agreements depending on the industry. It is important, therefore, for a startup franchisor to consider the long-term impact of the business and legal terms included in its franchise agreement, which means that new franchisors should carefully consider the long-term in vetting potential business and legal advisors.⁹ Keeping

⁶ This is not intended as an exhaustive list of all of the issues that a franchisor needs to address in establishing the structure of its franchise programs or preparing legal documents. For a more detailed discussion, see Michael H. Seid & Leonard D. Vines, *The Respective Roles of the Franchise Consultant and the Franchise Lawyer in Structuring the Franchise System*, ABA 30th Annual Forum on Franchising (2007).

⁷ See *infra*, Part 4 (information on the development, maintenance and use of Operations Manuals).

⁸ See *infra*, Part 3 (details on the development of a state registration strategy).

⁹ Michael H. Seid, co-author of the book, *Franchise Management For Dummies* (2017) by Michael H. Seid & Joyce Mazero, which discusses creating marketing plans and branding, and the secrets to continued success and future expansion, said "Most important for prospective franchisors is to understand that there are consultants and lawyers that we call franchise packagers. They offer cookie-cutter services—and that is a serious problem. Pick your advisors carefully and talk to their clients to understand their reputations." International Franchise Association, *Q&A with the Authors of Franchise*

in mind that development of a franchise system is a marathon, not a sprint, a new franchisor should select advisors who help guide and pace the franchisor from start to finish.

(2) Benchmarking with Similar Systems

As a new franchisor begins to develop the structure and terms of its franchise system, it must consider the terms of its new offering—some of which may be obvious (such as fees) and many others that are dictated by legal disclosure requirements (such as the average length of time between signing a franchise agreement and opening the franchised business). One of the first issues that the franchisor is likely to address is the fee structure for the franchise offering. Although a startup franchisor probably knows that common fees and charges in franchising include initial franchise fees, and ongoing royalty and marketing fees, it may not know how to determine the amount of those fees and whether they are “market.” The franchisor also needs to determine, among other things, whether and how much protected or exclusive territories to grant franchisees, the scope of the initial training program, and the type, frequency, and standards of any other initial and ongoing services provided.

As noted above, many of these terms will be fixed for the duration of long-term franchise agreements.¹⁰ And unfortunately, the franchisor may not actually realize there is a problem with the terms offered to franchisees until there are many franchises in the system, at which point any problems may be widespread (and may even lead to litigation). Although not every potential problem can be anticipated, some can. Franchisors should therefore thoroughly benchmark the system with other systems, engage in long-term planning, and discuss the proposed structure and terms with experienced franchise consultants and franchisor attorneys—from the outset.¹¹ For instance:

Management For Dummies, Interview by Robert Cresanti with Michael H. Seid & Joyce Mazero (Jun. 5, 2017), available at www.franchise.org/qa-with-the-authors-of-franchise-management-for-dummies.

¹⁰ A franchisor is not obligated to use the same form of agreement for the life of the franchise program and likely will update and modify its documents for new franchisees to reflect lessons learned and/or changes in the industry. However, if a franchisor can limit material changes to the franchise structure and documents over the years, it will be far simpler (and likely less expensive) to administer the franchise system.

¹¹ Franchisors also need to take into consideration the likelihood that the franchise concept’s brand and/or industry may change over time, and therefore reserve sufficient rights to unilaterally modify the franchise system to respond to brand and system changes. Of course, a key issue for franchisors and franchisees alike is understanding the distinction between a change to a brand “standard,” such as modification of a menu item or adding a mobile app in response to changes in consumer tastes and habits versus modification of a core term of the franchise agreement, such as increasing royalties. Therefore, the franchisor should discuss system changes with their legal counsel before

- Territorial Protection. Franchisors need to be careful about offering too large of an exclusive or protected territory that would prevent the franchisor from realizing sufficient market penetration, but should not delineate too small of an exclusive or protected territory that prevents a franchisee from building a profitable business.
- Initial Fees. Many startup franchisors make the mistake of setting too high a fee, which may become a bar to entry. Franchisors should ask themselves what franchisees get in return for this initial fee. How much does it cost the franchisor to provide initial services to franchisees, such as site selection and build-out assistance, the training program, and other opening assistance? How much does it cost the franchisor to develop a lead and close a sale? Finally, the new franchisor should consider that most successful franchisors generally focus on finding good prospects who will open the first franchises, be promoters of the concept, and pay royalties for many years, rather than maximizing initial franchise fees to cover operating costs. In fact, franchisors should not look at making a profit on initial franchise fees, but merely breaking even with their onboarding costs.
- Royalties and Other Ongoing Fees. Franchisors should discuss with their business advisors how to set appropriate fees so that both the franchisor and the franchisee have an opportunity to succeed. Since franchising essentially creates a symbiotic relationship, it is important for the franchisor to remember that its long-term success depends on creating a structure and system that provides an opportunity for franchisee success, including financial success.
- Initial Term and Successor Terms. A new franchisor will need to consider both business and legal issues in setting the length of the initial term. In addition, the franchisor will consider whether to offer successor or renewal terms, and if so: how many renewal terms, duration of renewal terms, and the conditions of renewal. Again, the franchisor must evaluate business issues (such as length of time necessary for franchisees to recover their initial investment and whether there is an industry standard for length of initial and successor terms), as well as legal implications (such as whether a particular state regulates the length of the term or whether contractual “windows” permitting either party to terminate the franchise agreement without cause at certain intervals are permissible or desirable).

implementation to determine whether: (a) any updates or amendments to the FDD are necessary; (b) such changes could adversely affect existing franchisees; and (c) formal amendments to existing franchise or ancillary agreements are required or recommended. See *infra*, Parts 2 and 4 (additional information on making system changes).

- Dispute Resolution Process. A startup franchisor may not be able to (or may not wish to) imagine the need to have a formal process for resolving disputes with franchisees. However, there are various methods of resolving disputes, including mediation, arbitration, and litigation, each with their own advantages and disadvantages when it comes to costs, time to a resolution, possibility of high jury awards, and privacy.

Of course, every industry differs, and there is no “one-size-fits-all” franchise structure. That said, when developing the terms of a franchise offering, franchisors have a variety of resources:

- Experienced franchise consultants who have seen and viewed numerous franchise offerings from different brands and may be able to provide guidance based on previous experience.
- Experienced franchise attorneys who have worked with franchisors at various stages of the franchise lifecycle (possibly including litigation), and who can point out issues that may be more likely to create legal risks to the franchisor and/or the franchise system.
- *Entrepreneur* magazine’s annual Franchise 500 list, which lists the financial requirements (including initial investment, net worth requirement, and liquid cash requirement), ongoing fees (including initial franchise fee, royalty fee, and marketing fee), financing options, and franchisor support required or offered by the top franchises may provide useful background information. Note, however, that this list is skewed towards dominant franchise brands.
- California,¹² Minnesota,¹³ and Wisconsin¹⁴ maintain publicly available online databases of FDDs filed in those states. Franchisors may find it useful to review competitor FDDs and terms of their offerings (such as fees payable by franchisees, territorial protections, etc.). Note, however, some exempt franchisors or franchise offerings are not available online, but private vendors may sell copies of FDDs.

Finally, as more and more franchises are sold, opened, and operated, franchisors may gain access to the best resource in the continued development and upgrading of the franchise system – existing franchisees who may provide valuable feedback on the overall franchise system and offering, including suggested improvements. To be

¹² Cal. Dept. of Business Oversight, Securities & Franchise Search, <https://docqnet.dbo.ca.gov/search> (last visited Apr. 13, 2018).

¹³ Minn. Dept. of Commerce, Commerce Actions and Regulatory Documents Search, <https://www.cards.commerce.state.mn.us/CARDS> (last visited Apr. 13, 2018).

¹⁴ Wis. Dept. of Financial Institutions, Franchise Search, <https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx> (last visited Apr. 13, 2018).

successful, the franchisor must be nimble in responding to and adopting constructive suggestions to improve and update the system.

b. Developing the Sales Program

In addition to establishing the structure and terms of the franchise system, another key task for the startup franchisor is to develop its sales program and procedures. Among other things (such as determining whether to use an internal sales team, franchise brokers, or a combination of the two), the franchisor should establish minimum franchisee qualifications, design franchise sales compliance procedures and training programs, and designate at least one individual to serve as administrator to oversee the compliance program. Startup franchisors may view the design of a sales compliance program and procedures as yet another time-consuming, costly activity that they can skip. Implementing strong sales programs and procedures from the beginning, however, will place the franchisor in the best position to attract well-qualified franchisees who will represent the brand well in the long-term. A strong franchise compliance program also may provide a written record to help a franchisor disprove any future claims that a sale was non-compliant.¹⁵ Finally, if the franchisor relies primarily on brokers and other outside consultants to assist with franchise sales, the sales compliance program and procedures should also account for the third-party involvement since the franchisor remains responsible for sales compliance.¹⁶

(1) Franchisee Qualifications and Evaluation Criteria

Startup and smaller franchisors may be tempted to identify new candidates and close deals quickly without carefully evaluating prospective franchisees. Failure to establish minimum qualifications and objective evaluation criteria for new franchisees, however, may yield franchisees with unrealistic expectations and/or inadequate capitalization, experience, or “fit” to successfully operate a franchised business and represent the franchisor’s brand.¹⁷ Requiring franchisees to meet minimum financial and

¹⁵ A non-compliant franchise sale occurs, for example, when the franchisor fails to provide full or timely disclosure; fails to update the FDD after a material change has occurred; makes unauthorized financial performance representations; or offers or sells franchises without registration (or an exemption) in franchise registration states. For a discussion of pre-sale disclosure mistakes, see Joseph J. Craciun & Andraya C. Firth, *To Err is Human: Remediating Mistakes in the Pre-Sale Disclosure Process*, IFA 44th Annual Legal Symposium (2011).

¹⁶ For more information on use of brokers in the sales process, see Greg Nathan, *Engineering Healthy Franchise Relationship*, ABA 32nd Annual Forum on Franchising (2009) at 21; and Donna Christopherson, Marc Kiekenapp & Joel Siegel, *Broker Liability: Minimizing the Business and Legal Risks Associated with Brokers and Other Third Parties*, IFA 40th Annual Legal Symposium (2007).

¹⁷ See Steven J. Vaughan, Mark Robertson & Nikki Gahr Sells, *Facing the Music before the Band Plays: Protecting the Franchise System Entrance with Franchisee Qualification Criteria*, IFA 42nd Annual Legal Symposium (2009) for detailed recommendations and

experience requirements and pass other objective background and business compliance checks also may protect franchisors from later allegations of discrimination.¹⁸

After establishing the minimum franchisee qualification criteria (such as \$x net worth, \$y liquid assets, z years' of management experience, no bankruptcies in the past n years, etc.), the franchisor should prepare an application that is designed to gather the information necessary to evaluate whether the prospective franchisee meets those standards.

Information commonly requested from prospective franchisees includes¹⁹:

- Balance sheet showing assets and liabilities (for both entities and their individual owners)
- Ownership structure and copies of organization documents for entity applicants
- Operational experience in the same industry as the franchised business
- Other business experience
- Business and personal references
- Operation or ownership of competing businesses
- Information on past or pending litigation, bankruptcies, or criminal convictions (which the franchisor may supplement via an independent background check)
- USA PATRIOT ACT representations (and compliance check by the franchisor)
- Credit and background check

analysis of the franchise application process and evaluation of prospective new franchisees; see *also* Nathan, *supra* note 16, at 29-32 for a detailed discussion on franchisee recruitment practices and the consequences of inadequate franchisee selection procedures, along with tips for improving the franchisee selection practices.

¹⁸ See *Elbanna v. Captain D's LLC*, Bus. Franchise Guide (CCH) ¶ 14,080 (M.D. Fla. 2009) (designated not for publication) (finding no evidence that franchisor's disapproval of prospective franchisee was based on race when franchisor asserted two legitimate non-discriminatory bases for rejection: failure to meet financial liquidity requirements; and deficient operations at outlets operated by the prospective franchisee in another franchise system).

¹⁹ Vaughan, Robertson & Sells, *supra* note 17, at 14-26.

Finally, it is important to remember that the application is only as good as the process—the franchisor must apply evaluation criteria consistently and avoid the temptation to relax standards for the founder’s best friend or other “rock star” candidates. Failure to do so may result in franchisees who are ill-equipped to develop and operate a franchise and possibly even discrimination claims against the franchisor.

(2) Sales Compliance Procedures and Training Programs

Sales Compliance Procedures. Another area where “an ounce of prevention is worth a pound of cure” is implementation of sales compliance procedures and training programs. The franchisor’s sales compliance program should include procedures to track contacts with prospective franchisees, franchise territories, and state registration filings, and may use spreadsheets and checklists designed by the franchisor or a more sophisticated software program developed by a third party. Regardless of the procedures and format of the sales compliance program, the franchisor must have a system to document and track the franchisor’s compliance with franchise law and other legal requirements, such as FDD delivery, receipts, holding periods, FDD versions, and state effective dates (and, later on, renewal dates, royalty rates, and other important agreement terms for existing franchisees).²⁰ A sample Closing Checklist for New Franchise Agreement that incorporates some of these items is attached as Appendix A.

The franchisor also should consider requiring that all prospective franchisees complete and sign a “compliance questionnaire” or “disclosure acknowledgment statement” before signing the franchise agreement. Doing so may help the franchisor identify and resolve potential legal issues before a deal is closed (or in extreme cases, cancel a deal altogether). Note, however, that the compliance questionnaire/disclosure acknowledgment statement is not a “silver bullet” that will fell all misrepresentation, fraud and similar claims made by franchisees.²¹ In addition, to avoid claims that a franchisee was coerced into submitting a clean compliance questionnaire, the franchisor must adopt procedures to ensure that franchisees complete the form independently, and that the resolution of any issues is documented.²² A sample Compliance Questionnaire/Disclosure Acknowledgment Statement is attached as Appendix B.

²⁰ See Harrison & Koch, *supra* note 3, at 8.

²¹ See Harrison & Koch, *supra* note 3, at 9; see also *Hetrick v. Ideal Image Development Corp.*, 758 F. Supp. 2d 1220 (M.D. Fla. 2010) (concluding that jury had found that a compliance questionnaire did not preclude franchisees from claiming reliance on oral statements by the franchisor’s representatives).

²² See *Martrano v. Quizno’s Franchise Co. L.L.C.*, No. 08-CV-0932, 2009 WL 1704469, Bus. Franchise Guide (CCH) ¶ 14,161 (W.D. Pa. June 15, 2009) (finding that disclosure acknowledgment statement was “deceptive” if franchisor had required franchisees to write “none” in the blank reserved for the franchisee to identify representations that it relied upon in deciding to purchase the franchise).

Training. All franchisor personnel involved in the sales process, including upper management of smaller franchisors, should participate in a franchise sales compliance training program. The franchisor may choose to participate in a sales compliance training program offered by a third party (such as the IFA), create a custom training program with the assistance of experienced franchise counsel, or use a combination of the two. Topics that the training should address include:

- Purpose of training – Creating a culture of compliance
- Background on franchising laws and regulations (including penalties for non-compliance)
- Item-by-item overview of the FDD
 - General requirements
 - Franchisor-specific disclosures
- Financial Performance Representations (including the rules regarding supplementary earnings claims made outside the FDD)
 - Definitions and Examples
 - General Media Claims
 - Do's and Don'ts
- 7-day and 14-day waiting periods
- Electronic disclosure of the FDD
- Receipts and recordkeeping
- State franchise relationship laws
- Advertising requirements (including state filing requirements)
- Material changes and amendments
- Quarterly and annual amendments

Any new additions to the sales team should undergo the basic sales compliance training—before they start making sales. The franchisor should also offer periodic refresher training to review the basic franchise sales compliance rules, as well as to cover changes in the franchise laws or the franchisor's offering (such as addition or deletion of a financial performance representation). Finally, each member of the sales team should have access to written sales compliance policies, manuals, and/or PowerPoint or other presentation documents, etc.

2. Preparation of the FDD: Estimated Initial Investment and Financial Performance Representations

After the franchisor (with or without the assistance of advisors, such as franchise consultants and franchise attorneys) has determined the overall structure and terms of the franchise program, it can turn to preparation of the franchise documents, including the

FDD.²³ Of the 23 items that the Amended Federal Trade Commission Rule (“FTC Franchise Rule”) requires franchisors to disclose to prospective franchisees,²⁴ Item 7 (Estimated Initial Investment) and Item 19 (Financial Performance Representations) are perhaps the most challenging disclosures, especially for startup and smaller franchisors.²⁵

“How much will it cost to operate the franchised business?”

“How much money can I make?”

Not surprisingly, these questions are paramount in the minds of most (if not all) prospective franchisees. For this reason, potential franchisees consider the Item 7 and Item 19 disclosures critical to their investment decision and business planning process. Not coincidentally, these disclosures also are widely considered by franchise practitioners

²³ A detailed discussion of issues involved in preparing the FDD and other franchise documents (including the franchise agreement and Operations Manual) is beyond the scope of this paper. However, there are numerous papers and articles that address these topics – see, e.g., Melanie Bootes, Scott Toop & David J. Kaufmann (moderator), *Advanced Franchise Agreement and Franchise Disclosure Document Drafting Techniques*, IFA 48th Annual Legal Symposium (2015); Max Staplin, Donna Christopherson & Connor Boyle, *Welcome to the Majors: Franchise Disclosure Basics for the Rookie Franchise Attorney*, IFA 48th Annual Legal Symposium (2015); and Leslie D. Curran & Benjamin L. Mitchell, *The Art and Science of FDD Drafting*, ABA 37th Annual Forum on Franchising (2014).

²⁴ 16 C.F.R. § 436.5 (2007). The FDD describes, in plain English, the history of the franchisor and the franchise system (e.g., length of time offering franchises and operating the type of business offered; litigation and bankruptcy history; number of outlets in the franchise system; and financial statements), the terms of the franchise agreement (e.g., initial and recurring fees, initial term and renewals, transfers, default and termination, and enforcement provisions), and the business the franchisee will operate (e.g., products and services offered, trademarks and other intellectual property used to identify the system, and required products and services that must be used to operate the business). The FDD is not a contract between the franchisor and franchisee, but rather an informational pre-sale disclosure document required by law. The franchise agreement and any ancillary contracts (such as licenses, leases, equipment purchase agreements, guaranties, etc.) are the binding contracts between the franchisor and each franchisee governing the franchise relationship.

²⁵ Another candidate for “most thorny” issue for startup franchisors is Item 21, “Financial Statements” and whether the franchisor can take advantage of the “phase-in” for use of audited financial statements. See 16 C.F.R. § 436.5(u)(2); Statement of Basis and Purpose, 72 FR 15443, 15511-15512 (Mar. 30, 2007); see also Staplin, Christopherson & Boyle, *supra* note 23, at 40-41.

to be among the most litigated provisions in the FDD, especially if estimated initial investments are understated or financial performance representations are overstated.²⁶

When drafted with care, Item 7 and Item 19 can be effective marketing tools to accelerate system growth. However, for startup and smaller franchisors, who may have no existing outlets (or just a few) from which to gather accurate and reliable data, Item 7 and Item 19 can present some unique disclosure challenges.

a. Item 7 (Estimated Initial Investment)

Item 7 requires the franchisor to disclose (in a prescribed tabular format), the prospective franchisee's estimated initial investment.²⁷ This includes all fees and expenses required by the franchise agreement and all other costs (whether payable to the franchisor, its affiliates, or third parties) necessary for the franchisee to begin operation of the franchised business plus any additional expenses incurred during the "initial period" of operations.²⁸

The FTC Franchise Rule does not prescribe a comprehensive list of the types of fees or expenses that must be included in the Item 7 table. The franchisor's actual estimated investment fee and expense types will necessarily vary based on a variety of factors, including the nature of the franchised business, the franchise business model, and the franchisor's industry.²⁹ However, the FTC Franchise Rule does provide some guidance to franchisors and lists typical fees and expenses that should be included in Item 7, if applicable. These include initial franchise fees (which should be consistent with Item 5), training expenses (which should be consistent with Items 5, 6 and 11), real property (purchase or lease), construction and leasehold improvements, furniture, fixtures, equipment, initial inventory, security deposits, utility deposits, business licenses and other prepaid expenses.³⁰ In addition, Item 7 must include any other payments (such

²⁶ See Keith Kanouse, Dawn Newton & Michelle Webster, *Fundamentals 201: Drafting the Six Most Challenging Items in the FDD*, ABA 38th Annual Forum on Franchising (2015) and Gregg A. Rubenstein & Robert Salkowski, *The Five Most Litigated Provisions in the Franchise Disclosure Document*, ABA 34th Annual Forum on Franchising (2011).

²⁷ 16 C.F.R. § 436.5(g). The Item 7 table must describe the type of fee or expense, the amount (usually presented as low-high range unless the actual amount is known), the method of payment (typically "lump sum" or "as-incurred"), the due date (e.g., before signing franchise agreement), and the party (or parties) to whom payment is made (usually the franchisor, its affiliates, or third parties or vendors). *Id.*

²⁸ *Id.* Federal Trade Commission, *Franchise Rule Compliance Guide* (May 2008), available at <https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf> (the "FTC Compliance Guide") at 48.

²⁹ *Id.*

³⁰ 16 C.F.R. § 436.5(g)(1); FTC Compliance Guide at 49.

as additional training, travel, or advertising expenses) a franchisee must make in order to begin operating the franchised business.³¹

The franchisor also must include in the Item 7 table an “additional funds” estimate that includes all other required expenses the franchisee will incur both pre-opening and during the “initial period” of operations.³² The franchisor must state the initial period in Item 19 and describe, in general terms, the factors, basis, and experience the franchisor considered or relied upon in preparing the additional funds estimate.³³ Other than this “additional funds” category, the expenses in Item 7 generally cover only the pre-opening period of the business.³⁴

In preparing the FDD, a startup franchisor must determine what initial period is reasonable for the franchised business. This will vary based on the industry and how long it typically takes for a new business in that industry to ramp up operations. Some significant factors are the amount of time it takes to complete the initial training program and the amount of time it takes to obtain property control and build out the facility. For instance, it is common for the “initial period” to be 6 months or more in the hospitality industry due to the length of time it takes to build a new lodging facility or convert an existing one to the franchisor’s brand. Reviewing FDDs of competitors across franchisor’s industry and calculating the time it takes the franchisor to open its own company-owned outlets (based on actual experience) are great starting points for determining the appropriate “initial period.”

Practice Point: The franchisor should check to ensure the total estimated initial investment figures from Item 7 match the total investment stated on the cover page of the FDD and also that any amounts disclosed in Item 7 that are paid to the franchisor (or its affiliates) are consistent with the initial fees described in Item 5. Franchise examiners typically check these amounts and may view inconsistencies as a sign that the FDD was poorly drafted.

³¹ 16 C.F.R. § 436.5(g)(1); FTC Compliance Guide at 49. In the authors’ experience, these amounts should also include legal and professional fees (for reviewing the FDD, negotiating the franchise agreement, forming the franchisee business entity, reviewing and negotiating the lease for the premises (if applicable), and obtaining any required business licenses/permits). It is common for franchisors to underestimate these fees. If the franchised business will be subject to substantial licensing requirements (for example, medical franchises or restaurants with liquor licenses), these costs can be significant and should not be overlooked.

³² 16 C.F.R. § 436.5(g)(1)(iii). While the FTC Franchise Rule does not define “initial period,” the FTC generally considers three months to be a reasonable period, unless a longer period is reasonable for the industry. FTC Compliance Guide at 49.

³³ 16 C.F.R. § 436.5(g)(1)(iii).

³⁴ FTC Compliance Guide at 48.

(1) Source of Information

The franchisor has an obligation to provide as accurate a statement of initial investment costs as possible in the Item 7 disclosure.³⁵ To do this, a startup franchisor will need to determine the costs incurred to locate, lease, construct, equip, and begin operations for its company-owned (or affiliate) outlets for the initial period of operations. It should conduct a detailed and methodical review of its own expenses for company outlets (from site selection through the initial period of operations) to ensure that each cost is accurately reflected in Item 7. Depending on the size and structure of the franchisor entity, this exercise may require gathering input from various functions or departments (e.g., real estate, facilities, supply chain, HR, etc.) and then tying out the numbers to ensure the franchisor has captured all costs and expenses. The franchisor must then incorporate fees and expenses that are unique to the franchisee (such as travel and living expenses while training and initial and ongoing fees payable to the franchisor), to get a full picture of what a franchisee's initial investment really looks like.

In carrying out this exercise, the franchisor and its business advisors should be sensitive to any economies of scale that may not translate over to franchised outlets. For example, centralized back-office support and/or management may result in the franchisor having less G&A expense compared to franchisees. In some cases, franchisees may have to pay higher prices for certain goods or services—for example, if franchisees do not benefit from discounted or volume pricing that the franchisor and its affiliates receive. These factors should be taken into account and appropriate adjustments should be made (and caveats included in the explanatory notes) when preparing the Item 7 disclosure.

Startup franchisors also may find it helpful to survey the Item 7 disclosures of their industry peers to help determine the types of fees and costs that should be included in the “estimated initial investment.” As noted in Part 1.a.(2) above, California, Minnesota and Wisconsin currently make franchisors' registration materials (including FDDs filed in those states) available at no charge via the state's website. Of course, competitor FDDs should be used for informational purposes only—the franchisor should not assume a particular term or proposed disclosure complies with the FTC Franchise Rule or state franchise laws.

Practice Point. A franchisor (especially a smaller or startup franchisor) should consider adding language to the franchise agreement to require new franchisees to report actual pre-opening costs and initial operating expenses using a form/format specified by

³⁵ See, e.g., *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc.*, Bus. Franchise Guide (CCH) ¶ 15,384, 70 F. Supp. 3d 376 (D.D.C. 2014) (involving alleged misrepresentation of start-up costs in FDD) and *Motor City Bagels, L.L.C. v. Am. Bagel Co.*, Bus. Franchise Guide (CCH) ¶ 11,654, 50 F. Supp. 2d 460 (D. Md. 1999) (finding that franchisees asserted triable claims of common law fraud and violation of statutory franchise disclosure requirements based on franchisor's failure to provide updated FDD that was available prior to the franchise sale and reflected substantially higher investment costs than the costs disclosed in the older FDD furnished to plaintiffs).

the franchisor. This will help the franchisor comply with its obligation to provide accurate cost data in Item 7.

(2) Preparation of Explanatory Notes

A franchisor should plan to dedicate extensive time to research and prepare the explanatory notes that accompany the Item 7 table. These footnotes are important because they allow the franchisor to provide explanations, definitions, and caveats that expand upon the summary information presented in the table. They also clarify the information by providing the assumptions that the franchisor used in preparing the estimates.

In the Item 7 explanatory notes, the franchisor should address each of the following:

- explain assumptions the franchisor used to determine the amounts in the table;
- state whether each fee is refundable (and if so, under what conditions);³⁶
- if the franchisor or its affiliate finances any portion of the initial investment, describe the financing terms (including amount financed, required down payment, annual interest rate, and estimated loan payments);³⁷
- if the amount for real estate (purchased or leased) cannot reasonably be estimated (using a low-high range) in the table, describe the size and probable location (e.g., shopping center, freestanding, downtown, rural, etc.);³⁸
- detail where certain expenses have been grouped together in the table;³⁹
- for any estimates presented as a low-high range, explain the reason for the difference between the low and high figures (and note that actual expenses may fall outside the low-high range on either end due to the franchisee's unique circumstances);⁴⁰

³⁶ 16 C.F.R. § 436.5(g)(7).

³⁷ *Id.* The franchisor may reference Item 10 for additional details about financing.

³⁸ 16 C.F.R. § 436.5(g)(2).

³⁹ For example, the computer system (hardware and software) may be lumped in with other equipment in the FF&E estimate. Any description (including cost) of the computer system in Item 7 should be checked to ensure consistency with the IT-related disclosures that appear Item 11.

⁴⁰ For example, construction costs may be based on square footage, with the low end of the range representing a smaller footprint (building size). Geography can impact the

- disclose characteristics of the outlets on which the estimates are based (e.g., geographic area; urban, suburban, large metropolitan area, etc.; whether union labor required, etc.) and note that differences in those characteristics may have an impact on the franchisee’s actual expenses; and
- if the franchisor is refranchising⁴¹ company-owned outlets and sold a company outlet in the preceding fiscal year for a sales price that exceeds the highest investment estimate in Item 7, disclose that fact in a footnote and indicate by how much the sales price exceeded the highest initial investment estimate.⁴²

In addition, because the “additional funds” category operates as a “catch-all” for operating costs and expenses during the initial period of operations, franchisors should explain fully (via footnote disclosure) the types of fees and expenses the franchisee can expect to incur⁴³ during the initial period and the assumptions used by the franchisor in preparing the “additional funds” estimate.

Finally, a franchisor may include additional (separate) tables in Item 7 to present separate investment estimates for other brands offered (in the case of a multi-concept franchisor that uses a single FDD) or for significant variations (e.g., size of premises or type of location) that significantly impact the total initial investment range.⁴⁴ These separate tables (if any) should also include their own accompanying explanatory notes. Similarly, if a franchisor offers area development rights, it may choose to present that information in a separate table in Item 7.

(3) Use in Franchise Sales Process

The Item 7 disclosure is particularly important to prospective franchisees because it answers, at least in part, the question “*How much will it cost to operate the franchised business?*” Prospective franchisee generally will use the Item 7 estimate as the basis for preparing their business plan and proformas. The Item 7 information is also commonly

franchisee’s actual expenses and should be considered – for example, construction costs may be significantly higher in states with unionized labor.

⁴¹ “Refranchising” generally refers to the process of selling company-owned outlets to prospective franchisees, thus converting the units to franchised outlets.

⁴² FTC Compliance Guide at 50.

⁴³ The additional funds estimate generally does not include a franchise owner’s salary or draw from the business; thus, the appropriate place to describe the franchise owner’s salary is in a footnote to the Item 7 chart. FTC Compliance Guide at 49.

⁴⁴ Franchisors may use separate tables wherever appropriate in the FDD, including also for Items 6, 17, and 20, if necessary. FTC Amended Franchise Rule FAQ #13, <https://www.ftc.gov/tips-advice/business-center/guidance/amended-franchise-rule-faqs#13> (last visited Apr. 20, 2018).

used by lenders in connection with franchisees' efforts to obtain financing. In a small or startup system, prospective franchisees will have difficulty gathering information from other sources since there may be few (if any) existing or former franchisees to validate the estimates presented in the FDD. For this reason, they may rely more heavily on the Item 7 disclosure. In discussing the initial investment estimates, franchisors should always remind prospective franchisees that the information presented in Item 7 is an estimate only and advise the franchisee to independently review the estimates with its own business advisors and consider local market conditions and other factors specific to the franchisee (as those conditions and factors are determined by the franchisee without input from the franchisor).

Practice Point. If a franchisor provides franchise prospects with cost and expense information outside of the FDD, it is important to make sure the information is consistent with the information contained in the FDD (Items 5, 6 and 7). This includes any figures presented in the "franchise opportunity" section of the brand's website, as well as figures included in any franchise sales or solicitation materials. The same is also true for FPR information, but with the added burden of making sure the franchisor complies with the rules for supplemental earnings claims and general media claims.⁴⁵

(4) Updating Information

A franchisor (of any size and experience) should develop and implement internal processes to ensure that information disclosed in the FDD is both current and accurate. A franchisor is required to (1) amend its FDD if there are any material changes to the information (which may be commonplace for new or emerging franchise systems); and (2) update (revise) the FDD annually for as long as the franchisor continues offering and selling franchises.

Unlike the fees in Items 5 and 6 of the FDD, which may remain unchanged for several years,⁴⁶ Item 7 requires more vigilance since initial investment estimates may vary based on changes in overall market conditions and other factors beyond the franchisor's control. There are many factors that can impact the Item 7 disclosure – for example, integration of new technologies, new or expanded product or service offerings, changes to the brand image, changing economic conditions or consumer demographics, legal and regulatory changes (e.g., menu labeling requirements), and the franchisor's expansion to new geographic markets, to name just a few. To keep pace with these

⁴⁵ See FTC Compliance Guide at 131-134 (requirements for general media representations); see also Stuart Hershman, David Koch, Peter Lagarias & James Susag, *Advanced FPRs: Writing, Using, Attacking and Defending Financial Performance Representations*, IFA 46th Annual Legal Symposium (2013) at 24-32 (discussing use of FPRs in franchise marketing materials).

⁴⁶ The fees and costs disclosed in Item 5 (initial fees) and Item 6 (other fees paid to the franchisor or affiliates) of the FDD typically do not change unless and until the franchisor revises its form franchise agreement and/or fee structure.

changes, the estimated initial investment should be updated on an annual basis and reviewed (at least quarterly) for any material changes - especially in the case of startup franchise systems, where initial investment costs may change more rapidly as the franchise system evolves.

A franchisor (of any size and experience) must develop and implement procedures to ensure that material changes do not go unreported due to internal communication breakdowns. The franchisor needs a reliable process to quickly identify changes that may be material and take appropriate action. One method is to require new franchisees to complete and submit surveys of their actual costs, as discussed below.

A. New Franchisee Surveys

As long as system growth continues, the franchisor should have information about startup costs for new outlets opened (whether company-owned or franchised) and should compare that information against the FDD to determine if changes are needed to ensure the accuracy of the estimates presented in Item 7. Some franchisors have a contractual right (via language in the franchise agreement) to require franchisees to report cost and expense data (typically in a form or format prescribed by the franchisor). In the absence of such a provision, the franchisor can still request that new franchisees voluntarily complete a survey or “statement of costs” that will enable the franchisor to gather and analyze the franchisees’ initial investment expenses to tie back to the Item 7 estimates. The form of the survey/statement/questionnaire should be prepared by the franchisor and be designed to categorize/calculate expenses consistently (as much as possible) from one franchisee to the next (and compared to company-owned outlets). Otherwise, the usefulness of the information greatly diminishes for purposes of Item 7.

To help ensure current and accurate responses, surveys should be sent to franchisees in a timely manner – for example, upon completion of construction and (perhaps also) once the franchised business has been operating for 3 months (or other “initial period” deemed reasonable by the franchisor for its industry). In that case, the second (supplemental) survey might focus just on the amount of working capital required for the initial period of operations (i.e., the “additional funds” estimate).⁴⁷

B. Amendment of FDD?

In addition to changes based on new franchisee experience, new or emerging franchise programs may experience frequent and significant changes as the system evolves and matures, some of which will affect initial investment estimates. Indeed, even mature franchise systems face such challenges as they invest ahead of growth and fight to keep their brands relevant with consumers.⁴⁸ To stay competitive, a franchisor may

⁴⁷ The franchisor should investigate any information received from a franchisee that is questionable or raises red flags.

⁴⁸ See David J. Kaufmann, Robert Zarco & Kenneth A. Cutshaw (contributing author), *Implementing System Upgrades and Enhancements: Business and Legal*

need to introduce new products or services that align with changed consumer demographics or tastes, which may increase the initial investment necessary to develop and open a franchised outlet.

For example, more than three decades ago, McDonald's modified its system to include breakfast.⁴⁹ As a result, existing and new McDonald's franchisees had to add extra labor and invest additional capital for training and unit renovations geared toward the new breakfast menu.⁵⁰ The additional costs associated with this type of change to the franchise system can be a "material change" that requires an amendment to update Item 7 (and possibly other FDD disclosure items) to avoid presenting misleading information to prospective franchisees. Even something as simple as integrating new technology or updating the brand image (especially for brick-and-mortar concepts) can materially impact a franchisee's investment costs and thus require the franchisor to re-think (and re-calculate) the Item 7 disclosure and amend the FDD.

If the franchisor concludes that there has been a material change (whether due to updates based on new franchisees' actual experience or from system-wide changes), it will need to review applicable federal and state laws to determine when the FDD and, if applicable, state registrations, must be amended. The FTC Franchise Rule requires franchisors to amend the FDD to reflect any material changes within a reasonable time after the end of each fiscal quarter.⁵¹ However, the timing requirements vary under state franchise registration laws (discussed in greater detail in Part 3 below) and may be more restrictive – i.e, some states require the FDD to be amended "promptly" or "within a reasonable time" while others require an amendment to be made within a certain number of days or before further franchise sales can occur. Appendix C summarizes the state deadlines to amend the FDD for material changes. If a material change does occur, the franchisor should instruct its franchise sales staff to suspend all franchise sales activities until the FDD has been revised and state franchise registrations (if applicable) have been amended.

b. Item 19: Financial Performance Representations

A franchisor (of any size or experience) must decide whether it wants to share any historical or projected financial performance information with prospective franchisees. "Financial performance representations ("FPR") are at the heart of the franchise sales process. No prospective franchisee buys a franchise without considerable thought as to

Considerations, IFA 44th Annual Legal Symposium (2011) (advanced discussion of challenges and considerations for implementing changes across the franchise system).

⁴⁹ *Id.* at 1.

⁵⁰ *Id.*

⁵¹ 16 C.F.R. § 436.7(b).

how it will perform financially.”⁵² Yet, despite the importance of financial performance information to franchise prospects, the franchisor has no obligation to provide an FPR as part of the franchise sales process. Under the FTC Franchise Rule and state franchise law, the franchisor may choose, but is not required, to make an FPR in the FDD.

(1) FPRs Generally

The FTC Franchise Rule broadly defines an FPR as:

any representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.⁵³

An FPR can be a historical representation about a system’s existing outlets or a forecast of prospective franchisees’ future financial performance (or a combination of both).⁵⁴ Of course, the majority of FPRs are historical because projections, by their very nature, are inherently riskier.⁵⁵

The franchisor has a great degree of latitude to decide what information to include (e.g., gross sales vs. net profits; historical vs. projected) and how to present the information (e.g., text, charts, graphs, text, etc.), but the FPR must be “based on the sort of factual information upon which a prudent businessperson would rely in making an investment decision.”⁵⁶ If the franchisor elects to make an FPR, the franchisor must have a reasonable basis and written substantiation for the FPR at the time it is made and must state the FPR in Item 19 of the FDD.⁵⁷

Some franchisors, especially startups or smaller systems, may face hurdles in collecting and reporting accurate data for preparation and substantiation of an FPR. For

⁵² W. Michael Garner & Earsa R. Jackson, *Litigating Unlawful FPR’s and Practical Tips for Doing So*, ABA 33rd Annual Forum on Franchising (2010) at 1.

⁵³ 16 C.F.R. § 436.1(e).

⁵⁴ 16 C.F.R. § 436.5(s)(3)(i). The franchisor must expressly state in Item 19 whether the FPR is a historical representation or financial projection. *Id.*

⁵⁵ Hershman, Kosh, Lagarias & Susag, *supra* note 45, at 14.

⁵⁶ See NASAA, *Commentary on Financial Performance Representations*, Introduction (May 2017), <http://www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf> (the “FPR Commentary”) (last visited Apr. 20, 2018).

⁵⁷ FTC Compliance Guide at 85.

example, their existing franchise agreements may lack provisions that require franchisees to report financial data (i.e., beyond revenue reporting for royalties and marketing fees). Even if the franchise agreement contains these provisions, the franchisor may lack the resources or personnel necessary to enforce compliance with these obligations or to review and compile the data. And, of course, many franchisors still fear that making an FPR exposes them to an increased risk of litigation at the hands of unhappy franchisees.⁵⁸

Despite any (real or perceived) disadvantages of making an FPR, the number of franchisors that include FPRs in Item 19 has continued to grow. By recent estimates, two-thirds of franchise systems currently make an FPR in their disclosure document.⁵⁹ This can be attributed, in large part, to the fact that today's prospective franchisees are more informed, more connected, and more demanding consumers; thus, they expect greater transparency when deciding where to invest their money.⁶⁰ They also have more choices since new brands continue to flood the franchise market and increase competition among franchisors vying for qualified franchise candidates.⁶¹

If, for whatever reason, a franchisor chooses not to include an FPR in the FDD, the franchisor is prohibited from sharing any financial performance information with prospective franchisees,⁶² other than the actual operating results of an outlet the prospective franchisee is considering purchasing.⁶³ If the franchisor elects to make an FPR in Item 19, the franchisor and its franchise sales staff must be careful not to provide

⁵⁸ See, e.g., Garner & Jackson, *supra* note 52 (discussing the various types of FPR violations and litigation strategies); see also Earsa R. Jackson, Harris J. Chernow & Michael Einbinder, *Death by Dangled Carrot – Litigating Financial Performance Representations*, IFA 49th Annual Legal Symposium (2016) (addressing various issues that often lead to disputes in connection with FPRs).

⁵⁹ FRANdata, *Financial Performance Representation: Market Demand Pushing Higher Levels of Transparency*, Special Report prepared for IFA Franchise Education and Research Foundation (April 2017) (the “FRANdata Special Report”) at 4.

⁶⁰ For an insightful review of consumers' increasing power in the marketplace, see *The Growing Power of Consumers*, Deloitte Consumer Review, 8th ed. (2014), www2.deloitte.com/content/dam/Deloitte/uk/Documents/consumer-business/consumer-review-8-the-growing-power-of-consumers.pdf (last visited Feb. 2, 2018).

⁶¹ See FRANdata Special Report at 6 (on average, 300 new brands start franchising each year).

⁶² 16 C.F.R. § 436.9(c).

⁶³ 16 C.F.R. § 436.5(s)(4). The operating results may be shared only with the particular franchise prospect that is considering purchasing the outlet.

(either orally or in writing) any information that conflicts with or goes beyond⁶⁴ the FPR presented in Item 19.⁶⁵

Although experienced and mature franchisors are (statistically) more likely to make FPRs, around 40% of new franchise systems also provide an FPR in their FDDs.⁶⁶ Below, we discuss the new FPR guidelines issued by NASAA⁶⁷ and how they impact the content and format of FPRs for small and startup franchisors. Under the new guidance, some FPRs commonly used by new or emerging franchise systems in the past are no longer acceptable.

(2) FPR Commentary

NASAA's much-anticipated Franchise Commentary on Financial Performance Representations (the "FPR Commentary")⁶⁸ was adopted on May 8, 2017. For most franchisors, it became effective on April 30, 2018.⁶⁹ The FPR Commentary supplements

⁶⁴ However, if the franchisor makes an FPR in its FDD, the franchisor may furnish prospective franchisees with supplemental financial information (apart from the FDD) about a particular location or variation (e.g., express location or kiosk). 16 C.F.R. § 436.5(s)(5). Any supplemental FPR must (i) be in writing; (ii) explain the departure from the FPR presented in Item 19; and (iii) meet all the same preparation requirements as the FPR that appears in the Item 19 disclosure. *Id.*

⁶⁵ 16 C.F.R. § 436.9(c). Unfortunately, whether a franchisor does or does not make an FPR in Item 19, the franchisor may still face claims that its representatives provided oral or written FPRs contradictory to, or outside of, the Item 19 disclosure. As noted in Part 1(B)(2) above, requiring new franchisees to complete and sign compliance questionnaires may overcome any such claims . . . but not always. For this reason, FPRs illustrate perfectly the idiom of "damned if you do, damned if you don't."

⁶⁶ FRANdata Special Report at 6.

⁶⁷ Organized in 1919, the North American Securities Administrators Association ("NASAA") is the oldest international organization devoted to investor protection. NASAA is a voluntary organization whose membership consists of 67 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, the U.S. Virgin Islands, Canada and Mexico.

⁶⁸ *NASAA Franchise Commentary on Financial Performance Representations*, North American Securities Administrators Association (May 8, 2017), www.nasaa.org/wp-content/uploads/2017/05/Financial-Performance-Representation-Commentary.pdf.

⁶⁹ The effective date for the FPR Commentary is the later of 180 days after the date of its adoption by NASAA or 120 days after a franchisor's next fiscal year end. Since many franchisors use a calendar year as their fiscal year, they will have updated their Item 19 FPRs to comply with the FPR Commentary by April 30, 2018, as part of the FDD annual update.

NASAA's 2008 Franchise Commentary⁷⁰ and provides additional guidance regarding a "reasonable basis" and substantiation for FPRs.⁷¹

A startup or smaller franchisor must consider a number of business and legal factors in determining whether to include an FPR in Item 19, and if so, what type of information to present.⁷² While the FTC Franchise Rule and FPR Commentary do not require a minimum number of outlets or period of operations that a franchisor must satisfy in order to make an FPR, a startup or newer franchisor should consider whether it has sufficient operating history and reliable reporting systems to satisfy the "reasonable basis" requirement. If the franchisor has a limited operating history and/or only a small number of outlets from which to gather data for the FPR, the risk of presenting misleading information to a potential franchisee increases.

Other key legal issues to consider include: when and how to present information from company-owned (or affiliate-owned) outlets in lieu of, or in combination with, data from franchised outlets; disclosure of gross sales⁷³ or net profit⁷⁴ information; use of subsets; presentation of historical FPRs versus projections (forecasts); and presentation of averages and medians.

The following table summarizes the FPR Commentary's new restrictions and requirements governing these issues:

⁷⁰ *Commentary on 2008 Franchise Registration and Disclosure Guidelines*, North American Securities Administrators Association (July 2008), http://www.nasaa.org/wp-content/uploads/2011/08/FranchiseCommentary_final.pdf (the "2008 Franchise Commentary") (last visited Apr. 20, 2018).

⁷¹ *Id.* at Introduction.

⁷² Business factors that the franchisor should consider in making this determination include industry standards (e.g., use of RevPAR and average daily rate in the hotel industry or average ticket in the quick-service restaurant industry), along with a careful analysis of the actual data collected by the franchisor.

⁷³ A franchisor making a gross sales FPR (whether characterized as "gross sales," "gross revenues" or a similar term) must define how it calculates gross sales for purposes of the Item 19 disclosure – i.e., the franchisor must disclose what items (if any) it is deducting from total revenue to arrive at its figure, including sales tax, discounts, allowances and returns. FPR Commentary at Item 19.4.

⁷⁴ Likewise, a franchisor making a net profit FPR (whether characterized as "net profit," "net income" or a similar term) must define how it calculates net profit for purposes of the Item 19 disclosure – i.e., the franchisor must disclose what items the franchisor is deducting from gross sales to arrive at its figure, including cost of goods sold, ordinary and recurring operating expenses, interest, income taxes, depreciation and amortization. FPR Commentary at Item 19.5.

Type of FPR	Company/Affiliate-Owned Outlets Only	Company/Affiliate-Owned and Franchised Outlets ⁷⁵	Other Considerations
Historical Gross Sales Based on Company-Owned Outlets Only	Permissible; must disclose material financial and operational characteristics of the company outlets that are reasonably anticipated to differ from future franchised outlets ⁷⁶	Prohibited if the franchisor has franchised outlets that have been fully operational for at least one full year (or one full season for seasonal franchise systems) ⁷⁷	Franchisors typically have access to gross sales information reported by franchisees and/or a contractual right (via the franchise agreement) to obtain gross sales information from franchisees. Thus, small or startup franchisors with operational outlets (any number) cannot reasonably base an FPR solely on gross sales of company outlets.
Historical Gross Sales Based on Company-Owned and Franchised Outlets	N/A	Permissible; must present data separately for company-owned and franchised outlets, except: If the franchisor has a “small” number of total franchisees (generally fewer than 10) ⁷⁸ whose	Once data for company outlets and franchised outlets has been presented separately, the franchisor may then also present the data in combined form in

⁷⁵ The franchisor must clearly identify the sources of all data presented in the FPR. FPR Commentary at Item 19.6. If the franchisor makes an FPR based on data from both company-owned and franchised outlets, it must clearly identify these 2 different types of data in Item 19. *Id.*

⁷⁶ FPR Commentary at Item 19.9.

⁷⁷ *Id.* at Item 19.8. A franchisor (regardless of size) that has “operational franchise outlets” lacks a reasonable basis to present an FPR based solely on gross sales of company-owned outlets. *Id.*

⁷⁸ *Id.* at Item 19.11. A franchisor with 10 or more franchisees is presumed to have a sufficient number of franchisees to require separate disclosure of data from company-owned outlets versus franchised outlets. *Id.* at n. 11. Note that here, the FPR Commentary refers to total “franchisees” not “franchised outlets.” In some systems, a

Type of FPR	Company/Affiliate-Owned Outlets Only	Company/Affiliate-Owned and Franchised Outlets ⁷⁵	Other Considerations
		identify is discernable, the data may be merged as long as there are no material differences in gross sales of franchised and company-owned outlets ⁷⁹	the Item 19 disclosure ⁸⁰
Historical Gross Profit/Net Profit Based on Company-Owned Outlets Only	Permissible; must include (a) actual costs incurred by company-owned outlets and (b) supplemental disclosure or adjustments to reflect all actual and reasonably expected material differences between company-owned and franchised outlets ⁸¹	Permissible; must include (a) gross sales data from “operational franchise outlets” (if franchisor has operational franchise outlets), (b) actual costs incurred by company-owned outlets, and (c) supplemental disclosure or adjustments to reflect all actual and	Supplemental disclosures or adjustments to reflect financial and operational differences must be presented clearly in Item 19 and appear in the same format as the rest of the FPR. ⁸³

single large, sophisticated franchisee may operate multiple franchised outlets across the brand.

⁷⁹ FPR Commentary at Item 19.11. The franchisor must include a representation in Item 19 stating that there are no material differences in the gross sales of company-owned and franchised outlets. *Id.*

⁸⁰ *Id.*

⁸¹ *Id.* at Item 19.10. If franchisees pay more for goods or services than the franchisor, the franchisor must adjust or supplement the FPR to include the costs a franchisee would incur. *Id.* The FPR must also be adjusted or supplemented to include imputed fees and expenses (such as royalties, advertising fund contributions and other fees not paid by company-owned outlets) and to account for any economies of scale specific to the franchisor (*e.g.*, centralized management and back-office support). *Id.*

⁸³ *Id.* For example, if the FPR presents data in a table or chart in Item 19, the differences between company and franchised outlets must be adjusted within or added to the end of the table or chart. *Id.* If the franchisor adjusts or supplements actual cost data in the FPR, it must clearly identify which data are actual costs versus adjusted costs and describe its method and rationale for determining adjusted or supplemental costs. *Id.* at Item 19.6.

Type of FPR	Company/Affiliate-Owned Outlets Only	Company/Affiliate-Owned and Franchised Outlets ⁷⁵	Other Considerations
		reasonably expected material differences between company-owned and franchised outlets ⁸²	
Financial Forecasts and Projections	Permissible; forecast must be based on historical data from outlets substantially similar to the type of outlet being offered (i.e., the same brand) ⁸⁴	Permissible; forecast must be based on historical data from outlets substantially similar to the type of outlet being offered (i.e., the same brand) ⁸⁵	Historical results may be adjusted or supplemented to reflect changes in the market ⁸⁶ , but projections cannot be based on results of other brands operated or licensed by the franchisor or its affiliates, on the results of similar or competitive brands, or on industry reports. ⁸⁷
Use of Subsets	Permissible only if there are 10 or more substantially similar outlets and the FPR has a reasonable basis, is accurate, and not misleading ⁸⁸	Permissible only if there are 10 or more substantially similar outlets and the FPR has a reasonable basis, is accurate, and not misleading ⁸⁹	If the FPR uses a subset of the system's highest-performing outlets, the FPR also must include a corresponding subset of the lowest performing outlets. ⁹⁰

⁸² *Id.*

⁸⁴ FPR Commentary at Item 19.20.

⁸⁵ *Id.*

⁸⁶ For example, rents that are higher or lower than historic rental amounts.

⁸⁷ FPR Commentary at Item 19.20.

⁸⁸ *Id.* at Item 19.14.

⁸⁹ *Id.*

⁹⁰ *Id.* at Item 19.13.

Type of FPR	Company/Affiliate-Owned Outlets Only	Company/Affiliate-Owned and Franchised Outlets ⁷⁵	Other Considerations
Average (“Mean”)	Permissible, but also must disclose the median of the numbers used to calculate the average and disclose the highest and lowest numbers in the range ⁹¹	Permissible, but also must disclose the median of the numbers used to calculate the average and disclose the highest and lowest numbers in the range ⁹²	May exclude data for outlets that closed during the time period covered by the FPR but must disclose in Item 19 the number of outlets that closed and how many of the excluded outlets closed after being open less than 12 months ⁹³
Median	Permissible, but also must disclose the average of the numbers used to calculate the median and disclose the highest and lowest numbers in the range ⁹⁴	Permissible, but also must disclose the average of the numbers used to calculate the median and disclose the highest and lowest numbers in the range ⁹⁵	May exclude data for outlets that closed during the time period covered by the FPR but must disclose in Item 19 the number of outlets that closed and how many of the excluded outlets closed after being open less than 12 months ⁹⁶

As described in the table above, the new FPR guidance re-confirms that subsets may be used to prepare FPRs, but it prohibits a franchisor with fewer than 10 substantially similar company-owned outlets and franchised outlets from basing the FPR on a subset of those outlets.⁹⁷ This does not preclude a small or startup franchisor (with fewer than

⁹¹ FPR Commentary at Item 19.16.

⁹² *Id.*

⁹³ *Id.* at Item 19.18.

⁹⁴ *Id.* at Item 19.17.

⁹⁵ *Id.*

⁹⁶ *Id.* at Item 19.18.

⁹⁷ A franchisor with fewer than 10 outlets (as of the end of its last fiscal year) is presumed to have too few outlets to reasonably base an FPR on a subset of those outlets. *Id.* at Item 19.14.

10 outlets) from making an FPR—the franchisor may still make an FPR in Item 19 as long as it has a reasonable basis for doing and does not use any subsets.

In addition, for a small or startup franchisor that wishes to present a financial forecast (projection) in Item 19, the prohibition on using historical results from the franchisor's (or its affiliates') other brands, competitive brands, or industry reports may prove especially challenging since the franchisor will have few (if any) existing outlets from which to gather the historical data needed to prepare the FPR. However, as noted above, the majority of franchisors providing an FPR choose to present historical financial performance information (versus projections).

(3) Use of Cost-Based FPRs

Cost and expense data, without more, is not an FPR.⁹⁸ However, cost information coupled with sales or earnings data rises to the level of an FPR and creates an Item 19 disclosure obligation.⁹⁹ The use of cost-based FPRs warrants discussion for the simple reason that, without cost data, prospective franchisees cannot assess the potential profitability of the franchised business. Despite this, the majority of franchisors that make an FPR provide gross revenues (top line sales), which tell prospective franchisees (and their lenders) only half the story.¹⁰⁰

Presenting profit data may be challenging for a franchisor (regardless of size) due to the availability and reliability of information regarding franchisees' operating costs and expenses. As summarized in Part 2.b(2) above, a franchisor may prepare a gross profit or net profit FPR for Item 19 based on company outlet data alone, as long as it has a reasonable basis for doing so and provides supplemental disclosure or adjustments that

⁹⁸ FTC Compliance Guide at 131; 2008 Franchise Commentary at Item 19.1. Although cost and expense data does not constitute an FPR under the FTC Franchise Rule, three franchise registration and disclosure states (Illinois, Maryland and Virginia) still include costs in the FPR information that cannot be provided to franchisees outside of Item 19. See Ill. Admin. Code tit. 14A, § App. A, Illus. L; Md. Regs. Code tit. 2, § 02.02.08.16; N.Y. Comp. Codes R. & Regs. tit 13 § 200.2(c).

⁹⁹ See 2008 Franchise Commentary at Item 19.1 (“If a franchisor provides information about a prospective franchisee’s anticipated operating expenses as a percentage of a stated level of revenue, that information constitutes a financial performance representation, and a franchisor may provide that information only if it complies with the requirements of Item 19”). Item 19 is triggered because the prospective franchisee can calculate average net profits using the combined data presented

¹⁰⁰ According to a recent market study conducted by FRANdata, 94% of franchisors that make an FPR present average unit revenues in Item 19. FRANdata Special Report at 4.

appropriately reflect all actual and reasonably anticipated material differences between company outlets and franchised outlets.¹⁰¹

See Part 2.b(2) above for a description of the FPR Commentary's restrictions related to gross profit and net profit FPRs.

3. State Franchise Registrations

While wrestling with preparation of Item 7, Item 19 (if applicable) and the rest of the FDD, the franchisor also must determine *where* it intends to offer franchises. Unless a startup or small franchisor intends to offer and open franchises nationwide—and has the financial, management, staff, and other resources to back this up—it is often a best practice to limit the geographic reach of its initial franchise offerings. For example, the startup or smaller franchisor may target potential franchisees only in the states in which it reasonably believes it may have prospects in the coming year and/or where it has sufficient resources (including sales staff, trainers, site selection and construction services assistance, grand opening assistance, and any ongoing support staff) to reasonably service franchisees. A startup or smaller franchisor also may limit franchise offers to prospective franchisees (and prospective franchised locations) in the state or region where the franchisor is currently located.

In addition to the business objectives noted above, the franchisor must also consider legal issues implicated by any proposed sales strategy. For example, a franchisor cannot sell franchises in the United States without an FDD that complies with the FTC Franchise Rule (unless an exemption or exclusion applies).¹⁰² In addition, 15 states¹⁰³ have separate registration and/or disclosure laws that also may apply to the offering (unless an exemption or exclusion applies).¹⁰⁴ As described in greater detail

¹⁰¹ FPR Commentary at Item 19.10. Adjustments include, for example, royalties and other fees required by the franchise agreement, and any additional costs (or higher costs) the franchisee would incur relative to company-operated outlets.

¹⁰² 16 C.F.R. § 436.8. A detailed discussion of exemptions is beyond the scope of this paper. See *Exemptions and Exclusions Under Federal and State Franchise Registration and Disclosure Laws* (Leslie D. Curran & Beata Krakus, eds. 2017).

¹⁰³ California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.

¹⁰⁴ State-by-state exclusions and exemptions vary widely. One potential exemption from registration available in some states is the isolated sale exemption, which permits a franchisor to make usually one sale in the state without registering. This exemption may be useful for “testing the waters” in the state or if the franchisor only intends to have one prospect in the state. *E.g.*, Minn. Stat. § 80C.03. Another useful exemption is the fractional franchise exemption, which permits a franchisor to sell an add-on business to a prospect's existing business, subject to certain conditions. *E.g.*, Minn. Stat. § 80C.01,

below, many of the remaining 36 states have business opportunity laws that also require pre-sale disclosure and registration, unless an exemption to the business opportunity law applies.¹⁰⁵ To successfully navigate the complex web of federal and state franchise and business opportunity registration and disclosure laws (and possible exemptions), the franchisor should consult regularly with franchise counsel in the early stages of developing a sales strategy. Among other things, the franchisor and its counsel should consider the following in developing the franchise offering target markets: (1) state franchise registration and disclosure laws; (2) impact of the franchisor's financial condition on state registrations; and (3) applicability of state business opportunity laws.

(1) Franchise Registration Laws

Before launching its sales program, the franchisor must understand whether the state or states where it intends to offer franchises has a franchise law regulating sales, and if so how that law may affect sales efforts. Although the FTC Franchise Rule does not require franchisors to register their offerings with the FTC or other authority, the following 14 states do require franchisors to register (unless an exemption applies): California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin.¹⁰⁶ In most of these states, a franchisor must register its FDD (together with the Franchise Agreement and ancillary contracts) with the state regulatory agency before it can make any offers (including circulation of advertising materials) or sales of franchised businesses to be located in that state and/or to residents of that state (unless an exemption applies).

Some of the registration states require "notice" filings only, while others perform a more thorough review of the FDD. Many of these states also require franchisors to include specific disclaimers and modifications to address areas where the state law

subd. 18; N.Y. Comp. Codes R. & Regs. § 200.10(2). See also Curran & Krakus, *supra* note 102.

¹⁰⁵ Common exemptions and exclusions include offers made in connection with the license of a federally registered trademark. *E.g.*, La. Rev. Stat., tit. 51, § 1821(d); see also Beata Krakus & Alexander G. Tuneski, *Caught in the Web of Federal and State Business Opportunity Laws: Managing and Avoiding the Entanglement of Regulations*, 36th Annual Forum on Franchising (2013).

¹⁰⁶ Cal. Corp. Code §§ 31000-516; Haw. Rev. Statutes Ch. 482E; Ill. Stat. § 705/1 *et seq.*; Ind. Code Ch. 2.5; Md. Bus. Reg. Code §§ 14-201 to -233; Mich. Comp. Laws Ch. 445; Minn. Stat. Ch. 80C; N.Y. Gen. Bus. Law §§ 680-695; N.D. Cent. Code Ch. 51-19; R.I. Gen. Laws Ch. 28.1; S.D. Code. Laws Ch. 37-5B; Virginia Code §§ 13.1-557 to -574; Wash. Rev. Code Ch. 19.100; Wis. Stat. Ch. 553.

greater protection to the franchisee than the FTC Franchise Rule does.¹⁰⁷ Although state-required disclaimers and modifications are typically incorporated in state-specific addenda to the FDD, Franchise Agreement, and ancillary contracts, in some cases, the additional disclosures may be added as “Risk Factors” to the State Cover Page of the FDD. As a result, a nationwide sales strategy can complicate both the FDD drafting and compliance process since the franchisor may need to prepare and track multiple versions of the FDD to comply with all 16 franchise laws and possibly many more business opportunity laws (discussed below).

Startup or smaller franchisors should also consider the state registration process itself in evaluating whether to register in a particular state. For example, the registration states impose a registration fee for initial (first time) filings and for each annual renewal. (See Appendix D for these fees.) It also may be useful to consider the standard review process used by the various states to determine how difficult it would be to add a state registration mid-year if the franchisor has a good prospect in that state. For example, certain states, such as Indiana, Michigan, South Dakota, and Wisconsin, typically require “notice” only registrations that are effective upon receipt.¹⁰⁸ On the other hand, some of the other states generally conduct a thorough review of initial registration applications, and therefore the franchisor may need to wait 4-6 weeks or longer (depending on the time of year and extent of any comments) before the registration is made effective. Finally, the franchisor should note that it may incur added expenses if one or more states issues detailed “deficiency letters” requiring revisions to the FDD or other documents (which, if material, may require the franchisor to amend registrations in other states), additional research, preparation of responses, and/or teleconferences with state franchise examiners.

In sum, the more states in which the franchise offered, the more complicated (and expensive) the sales process is likely to become due to required modifications to documents, registration fees, the state FDD review process, and the need to understand individual state legal requirements related to the offer and sale of franchises, as well as maintenance of the FDD.

(2) Financial Condition of Franchisor and Impact on State Registration Strategy

Another issue for the franchisor to consider in developing its sales strategy is whether a particular registration state might impose additional conditions to registration due to the franchisor’s financial condition. As noted above, in several registration states, a franchise examiner will perform a comprehensive review of the franchise documents to

¹⁰⁷ Although the FTC Franchise Rule is a federal law applicable in all states, it merely sets the floor for the issues addressed and does not preempt state laws that provide greater protection to franchisees. 16 C.F.R. § 436.10(b).

¹⁰⁸ *E.g.*, Ind. Code, tit. 23, art. 2, ch. 2.5, § 10.5(d); Mich. Stat. § 445.1507a; S.D. Stat. § 37-5B-5; Wis. Stat. § 553.26.

confirm that they comply with applicable law. In addition, the franchise examiners will review the franchisor's financial statements carefully to determine whether the franchisor has sufficient assets to perform the obligations and services promised to franchisees.

State statutes and regulations do not provide details on how the franchise examiner determines the adequacy of the franchisor's financial resources; however, state examiners may focus on all or some of the following measures in their review: cash flow, current and quick ratios, net worth, and net income analysis.¹⁰⁹ Franchise examiners also will consider the number of projected franchise openings disclosed in Item 20 and the franchisor's estimated costs in providing pre-opening services listed in "Form B – Franchisor's Costs and Source of Funds" of the application.

If the state examiner determines that the franchisor is inadequately capitalized,¹¹⁰ he or she may require that the franchisor provide "financial assurances" by either: depositing initial franchisee fees and other funds collected from franchisees before the franchisor has satisfied its pre-opening obligations into an escrow account with a bank that meets the state's requirements; deferring initial fees,¹¹¹ or, depending upon the state, posting a surety bond. (States generally permit the franchisor to choose among the options for complying with the escrow/impound condition and may permit the franchisor to use more than one option, such as escrows or impounds for new franchised outlets, and fee deferrals for conversion or transfers).¹¹²

The following table summarizes the advantages and disadvantages of each method for providing financial assurances:

¹⁰⁹ See Christina M. Noyes & Peter H. Dosik, *Oh No, Is That Really a Material Change? Disclosure, Exemption and Registration Issues in Challenging Economic Times*, IFA 44th Annual Legal Symposium (2011) at 28-30 for a detailed discussion of the process that various states use to review the franchisor's financial condition, as well as the requirements of escrow, fee deferral, and surety bonds.

¹¹⁰ In addition, Maryland and Washington generally require financial assurances for startup franchisors or "development companies," regardless of the financial indicators on the balance sheet. See Dale Cantone, Martin Cordell, Warren Lee Lewis & Felicia N. Soler, *Is Your System Compliant? Recent Changes and Hot Issues in Federal and State Franchise Regulation*, ABA 34th Annual Forum on Franchising (2015) at 40.

¹¹¹ Not all state statutes provide for fee deferrals; however, the state franchise examiner may permit the franchisor to comply with an escrow condition by deferring fees if requested.

¹¹² A franchisor also may be able to satisfy the financial assurances condition by using audited financial statements from a parent or affiliate with a stronger financial condition (and that provides a guaranty of the franchisor's obligations) or a capital infusion in an amount acceptable to the franchise examiner.

Method	Advantages	Disadvantages
Escrow or impound	Assurance that the franchisee will have funds to pay initial fees when the franchisor has met its pre-opening obligations.	Time, administrative burden, and costs and expenses incurred in: (1) locating a bank that meets the state's standards and establishing the escrow account, (2) maintaining the account; (3) preparing and submitting documentation to the franchise examiner to demonstrate that the franchisor has met its pre-opening obligations; (4) submitting account records to the franchise examiner; and (5) waiting for the state to authorize the release of the funds.
Fee Deferral	Simplicity – no additional bank accounts or state involvement are required.	Uncertainty – since the initial fees will not be deposited in a separate account, the franchisor must provide training and other pre-opening assistance without any assurance that the franchisee will ultimately pay the agreed-upon initial fees. If the franchisee does not pay, the franchisor may have to initiate default and termination proceedings – again, without assurance that the franchisee can ultimately pay.
Surety Bond ¹¹³	Franchisor's ability to collect fees as provided in the franchise agreement without waiting for pre-opening obligations to be fulfilled.	Time required to locate an insurance company that both offers commercial bonds in the applicable state(s) and will agree to underwrite the bond. Costs associated with the bond (or providing multiple bonds), which will typically be 1% of the bond amount for one year. ¹¹⁴ The bond amount is set by the state and typically will be either the amount of the franchisor's initial franchise fee or an amount equal to all Item 7 fees multiplied by the number of anticipated franchise sales disclosed in Table 5 of Item 20). ¹¹⁵

¹¹³ See 20 The Franchise Lawyer, C. Christian Thompson, Kara K. Martin, Nate Whitaker, and Heidi Coccimiglio, *Bonding: What It Is and How to Do It*, (Fall 2017) for a detailed analysis of state surety bond requirements.

¹¹⁴ See *id.* at 12.

¹¹⁵ See *id.*

(3) Business Opportunity Laws

Another consideration in developing the franchise sales strategy is whether a state has a business opportunity law that may apply to the franchise offering. In addition to franchise laws, about half of the states have business opportunity laws with registration and disclosure (and filing fee) requirements that may apply to any franchise offered in that state,¹¹⁶ though franchises offered in connection with the license of a federally registered trademark and/or otherwise comply with the FTC Franchise Rule are excluded or exempt from the majority of the state business opportunity laws.¹¹⁷

Practice Point: The following summarizes some of the key legal issues that a startup of smaller franchisor should consider in determining where to focus its sales (and franchise registration) efforts:

- Franchisor Resources. Does the franchisor have adequate capital, management, staffing, and other resources to conduct sales and provide pre-opening and ongoing services and support in the state? (If “No,” the franchisor should probably postpone efforts in the state until it does have adequate resources.)
- State Franchise Registration Law. Does the state have a franchise registration law? If “Yes”:
 - Do the franchisor, the franchise offering, prospective franchisees, and/or likely franchise sales transactions qualify for an exemption?
 - Does the franchisor intend to offer franchises in a state that borders the registration state in question?
 - If “yes,” the franchisor should consider whether the registration state’s law applies to its residents regardless of the location of the

¹¹⁶ 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 business opportunity laws.

¹¹⁷ Alaska, Arizona, California, Florida (if a simple notice is filed), Illinois, Indiana, Iowa, Kentucky (if a simple notice is filed), Maryland, Michigan, Nebraska (if a simple notice is filed), Ohio, Oklahoma, South Dakota, Texas (if a simple notice is filed), Utah (if a simple notice is filed), Virginia, and Washington generally exempt franchises (as defined under the FTC Franchise Rule) from complying with the state’s business opportunity law. Alaska, Arizona, Connecticut, Florida, Georgia, Illinois, Iowa, Louisiana, Maine, Maryland, Michigan, North Carolina, Oklahoma, South Carolina, South Dakota, and Washington also exempt marketing programs with *federally* registered trademarks. See Krakus & Tuneski, *supra* note 105.

franchised business (e.g., franchisor located in Delaware, which borders Maryland).

- What is the initial filing fee in the state?
- What is the registration process in the state (i.e., notice filing or more comprehensive review)? If a notice filing, the franchisor should be able to add the state mid-year without much difficulty if a good prospect emerges
- What is the likelihood that the state will request financial assurances?
- State Business Opportunity Law. Does the state have a business opportunity law?
 - If “Yes”: Does the franchise offering qualify for an exemption?

Although there is no “right” answer for determining the state or states in which the franchisor should offer sales, carefully evaluating the issues may enable the franchisor to focus its efforts. In addition, it is important to note that a review of the franchisor’s business objectives may produce a sales strategy that differs from one focused solely on franchise registration issues. For example, a franchisor and its business advisors may decide to focus sales efforts on a small number of states with no plans for further expansion, which typically would result in fewer state franchise registrations. If the franchisor would consider additional expansion under the right circumstances (and it has the resources to do so), however, it may wish to register in states that require a more comprehensive review from the beginning so that it will be ready to act if warranted. And regardless of the state sales strategy implemented by the franchisor, it must still comply with the FTC Franchise Rule in its franchise sales activities (unless an exemption or exclusion applies).

4. Managing Franchisee Relations¹¹⁸ Successfully: Overcoming Challenges for Startup and Smaller Franchisors¹¹⁹

Amidst the enthusiasm of structuring the franchise program and completing the business plan, the FDD, and other pre-launch items, it is important that the franchisor not

¹¹⁸ For purposes of this paper, unless otherwise noted, the terms, “franchisee relations” or “franchisee relationships” refer to the broad, ongoing business relationship between the franchisor and the franchisee, rather than transfer, termination, non-renewal, anti-discrimination, and other issues that 27 U.S. jurisdictions currently regulate via generally applicable franchise relationship laws.

¹¹⁹ For additional information on challenges faced by startup and smaller franchisors, see Lynne M. Hanson, Michael R. Daigle & Michael Nolan, *Advising New and Emerging Franchisors on Their Journey to the Next Level (Legal Hurdles and Opportunities)*, IFA 49th Annual Legal Symposium (2016); James Ullman & Melanie Bergeron, *Top 10 Pitfalls for Startup Franchisors*, IFA 44th Annual Legal Symposium (2011); Harrison & Koch, *supra* note 3; and Rocco Fiorentino, Marisa Faunce & Michael Seid, *Helping Franchisee Systems Succeed: Avoiding the Pitfalls Encountered in the Early Stages of Franchising*, IFA 41st Annual Legal Symposium (2008) (discussing “Top 10 Pitfalls” encountered in

lose sight of what really drives the franchising model—the relationships between the franchisor and its franchisees. This is not to suggest that brand recognition, compliance with franchise laws, and monitoring key performance indicators and other business metrics are unimportant, but rather to highlight the uniqueness of the franchise model.¹²⁰ As one commentator put it,

...the relationship between a franchisor and its franchisees is influenced by a range of factors which go beyond legal contracts. A contract may signify the presence of a relationship, but the contract is not the relationship, just as the power plug on a wall is not the electricity.¹²¹

This Part 4, therefore, examines several legal challenges that startup and smaller franchisors often face through the prism of the overall legal, commercial, and psychological relationship¹²² between the franchisor and its franchisees while recognizing that startup and smaller franchisors may face unique challenges in managing franchisee relations because of limited financial and management resources and possibly a small geographic footprint. These challenges include: (a) fulfilling franchisor obligations and developing the franchise system; (b) enforcement of system standards; (c) pace of system expansion; and (d) nurturing existing franchisees.

a. Fulfilling Franchisor Obligations and Developing the Franchise System

A couple of obvious ways for a franchisor to build healthy relationships with its franchisees are to fulfill its own obligations under the franchise agreement and to monitor and develop the franchise system to keep pace with industry and overall market changes. Larger, established franchisors typically have teams and departments (such as training, marketing, real estate, IT, brand standards, franchisee liaisons, etc.) devoted to these tasks. Startup and smaller franchisees with lean management teams and more limited

the early stages of franchising). A summary of the topics that made the “Top 10 Pitfalls” in past program papers is attached as Appendix F.

¹²⁰ See Michael Seid & Dave Thomas, *Franchising for Dummies*, 20-21 (2016). Nor is this to suggest that, legally, the franchise relationship is a fiduciary relationship, employment relationship, or anything other than a contractual relationship between independent parties.

¹²¹ See Nathan, *supra* note 16, at 3.; see also Dean T. Fournais, Sherin Sakr & Sue Vendittelli, *Establishing Effective Early Intervention Programs to Manage Day-to-Day Disputes, System Standards Compliance and System Changes*, ABA 32nd Annual Forum on Franchising (2009) at 1 (“Franchisors and franchisees with strong working relationships operate on a level above the four corners of their written contracts. They have relationships built on respect, mutual interest, culture and trust.”)

¹²² See Nathan, *supra* note 16, at 5-6 (describing the three perspectives that comprise the franchise relationship: legal, commercial, and psychological (which includes franchisee trust levels and commitment)).

financial resources may be tempted to cut corners and handle franchisee relationship and system development issues on an ad-hoc, as-necessary basis as the first few franchisees proceed through the franchise life cycle. Doing so may save time and money at the outset, but may lead to chaos later when the franchisor is trying to balance new franchise sales efforts, new franchisee development, training and openings, supply chain issues, ongoing marketing campaigns and other issues with efforts to respond to and manage disgruntled franchisees.

Instead (and ideally before the first sale), even the smallest franchisor should design policies and procedures to fulfill its obligations to the franchisees and monitor the system. Creating policies and procedures will not guarantee that every franchisee will be successful and happy; however, failure to do so may lead to dissatisfied franchisees and possibly to litigation. At the same time, the franchisor's policies and procedures must not be so rigid as to prevent a franchisor from exercising common sense in response to unique circumstances or system changes.

Detailed procedures (à la ISO Standard Operating Procedures) to address every possible issue may not be practical or cost-effective for smaller franchisors. At a minimum, however, all franchisors should develop general policies and procedures (and assign a responsible team member) to ensure that the franchisor can successfully: (1) meet its obligations to provide initial and ongoing assistance to franchisees; (2) develop the franchise system through new brand initiatives or modifications; and (3) modify and upgrade technology to improve the system and franchisee performance.

(1) Initial and Ongoing Assistance

The franchise agreement generally establishes the franchisor's obligations to provide initial and ongoing assistance, which typically include initial and ongoing training, site selection and construction/build-out assistance, marketing, maintenance and delivery of the Operations Manual, designation of approved suppliers, quality assurance reviews (addressed in Part 4.a.(3) below), and other assistance depending upon the franchisor and the industry.

- Initial and Ongoing Training. To meet Item 11 disclosure obligations, the franchisor must develop an initial training program before launching sales. Beyond FDD requirements, failure to develop an adequate training program or hold training as frequently as necessary to meet the on-boarding needs of franchisees may lead to a number of disastrous results, including ill-prepared franchisees who damage the brand, unhappy franchisees who are unable to operate a successful business, and eventually, litigation.¹²³ Similarly, even if the initial training program is well-designed and well-

¹²³ See *Le Macaron, LLC v. Le Macaron Development LLC*, No. 8:16-CV-918-17TGW 2016 WL 6211718 (M.D. Fla. Oct. 24, 2016) (not designated for publication) (denying franchisor's motion to dismiss claim that the franchisor breached the Franchise Agreement by failing to provide grand opening assistance, failing to place information about the franchisee's location on the website, and failing to provide marketing and advertising assistance).

received by franchisees, failure to provide continuing training and assistance (both informal and formal) likely will yield the same results. At the same time, all franchisors can expect to modify and adapt the initial training program over time to respond to changes in the system and industry, as well as to address issues identified in earlier training sessions and/or innovations in training techniques.

Practice Point. To meet training obligations under the franchise agreement, startup and smaller franchisors may consider several options, including: providing initial training at the franchisee's site or a regional site; outsourcing non-brand standard parts of the initial and ongoing training; and/or conducting webinars or other distance training methods.

- Site Selection and Construction/Build-out Assistance. A small franchisor without a real estate department or manager may not have the necessary resources to provide site selection and design and construction assistance in-house. The franchisor may choose to delegate some of its responsibilities to consultants,¹²⁴ require franchisees to engage third parties (who may be approved suppliers) to assist in these areas, or consider a 21st solution and incorporate artificial intelligence (“A.I.”) into the site selection process (which may reduce both time and cost associated with site selection review).¹²⁵ However the franchisor proceeds, it should: (a) develop objective site selection criteria that reflect the needs of the brand; (b) if appropriate for the brand, provide a template for model/sample construction plans; (c) review all proposed sites and construction plans; (d) make the final decision to approve a site or construction plans as meeting brand standards (or not); and (e) communicate that decision to the franchisee without making any representations or guarantees about whether a site will be profitable or whether a construction plan complies with applicable law, including the Americans with Disabilities Act and local building codes.

¹²⁴ In several places throughout this paper, we suggest that startup and smaller franchisors engage business advisors (such as third-party consultants) to assist with various activities. Before engaging a third party to fulfill a franchisor's obligations to franchisees, however, the franchisor must: (a) confirm that it has the right to delegate its duties under the franchise agreement; (b) retain final decision-making authority; and (c) provide appropriate training and guidance to the third party – including instructions on communicating with franchisees to avoid making unauthorized promises or representations. In addition, depending upon the involvement with the franchisees, a third-party consultant may also need to be disclosed in Item 2 of the FDD.

¹²⁵ See Keenan Baldwin, *The Impact of A.I. on the Franchise World*, Franchising World, at 48 (July 2017). Marketing and supply chain management (discussed below) are two other areas where franchisors may be able to use A.I. to assist in fulfilling its obligations to franchisees.

- Marketing. A franchisor’s marketing efforts to develop brand recognition can be a source of tension and even litigation between franchisees who expect to see a return on investment in their local market and franchisors that must focus on promoting the overall system.¹²⁶ This tension may be magnified in startup and smaller systems. For example, a startup franchisor may initially focus marketing efforts on required local marketing by franchisees to develop brand awareness in new geographic areas. If the franchisor has not yet have established a national advertising fund, franchisees may complain that the franchisor isn’t doing enough to support and promote the brand – even if the franchisor is providing marketing materials or templates and assisting in development of the local marketing strategy. Once the national fund is established, the startup or smaller franchise system may not collect a sufficient amount of fees in its early years to develop meaningful marketing efforts and may instead elect to carry funds over to the next year if the franchise agreement permits it to do so.

Another marketing issue that all franchisors – large or small, inexperienced or well-established – now need to address is social media. Regardless of the franchisor’s size and experience, it must develop and communicate a social media policy to franchisees.¹²⁷

Practice Point. If the startup or smaller franchisor operates outlets of its own, those outlets should contribute to any franchise advertising fund in the same manner that franchised outlets do. If it is not practical to do so because of accounting or other reasons, the franchisor should be prepared to demonstrate to franchisees the marketing efforts that the company- or affiliate-operated outlets have made. In addition, if the franchisor intends to establish regional marketing cooperatives (“Coops”), it should ensure that organization documents for the Coop clearly define the respective roles of the Coop and the franchisor, including which party has authority to make final decisions.¹²⁸

¹²⁶ See Stephane Teasdale, Robert A. Lauer & Stephanie Russ, *Who is Responsible When the Brand Falts?*, ABA 38th Annual Forum on Franchising (2015).

¹²⁷ See Ellen T. Berge, Susan Crane & Dominic Mochrie, *Reddit and Weep? Protecting Your Brand and Reputation in Social Media – A Continuum of Approaches from Engagement to Litigation*, IFA 50th Annual Legal Symposium (2017) (discussing legal standards regarding social media, development of social media policies, and brand protection); see also Olivia Maria Baratta, Michael Daigle, Elisa Edlund & Mindy Golde, *Getting Ahead of the Curve: Controlling the Risk of Social Media*, IFA 45th Annual Legal Symposium (2012) (including sample Social Media Policies).

¹²⁸ See *KFC Nat’l Council and Advertising Co-op, Inc. v. KFC Corp.*, No. 5191-VCS 2011 WL 350415 (Del. Ch. Jan. 31, 2011).

- The Operations Manual. One hallmark of a franchise system is a dynamic Operations Manual that “serves as the main tool for the franchisor to maintain uniformity, quality, and control over the daily operations of franchisees.”¹²⁹ It is critical, therefore, for a new franchisor to develop a comprehensive manual addressing required brand standards and recommended policies for operating a franchised business. Equally important, the franchisor must update the Operations Manual as necessary to reflect changes in brand standards, new policies, or new products and services.

For startup and smaller franchisees, maintaining and updating the Operations Manual may seem to be overly burdensome when facing the day-to-day operational issues of managing the franchise system, especially if “the Operations Manual” actually comprises various operations manuals, policy manuals, training manuals, memoranda, directive, instructions, etc. Failure to maintain the Operations Manual and provide updates to the franchisees, however, can lead to confusion about brand standard requirements or the inability of the franchisor to enforce a standard that is not adequately described in the Operations Manual.

Practice Point. Startup and smaller franchisors may outsource development and drafting of the original Operations Manual and periodic comprehensive updates to a third party; however, a franchisor (of any size and experience) must design and implement a process to develop, implement, and monitor any “Policy Statements” or similar documents issued from time to time to address new procedures, new standards, or similar issues as they arise. Additionally, the franchisor should designate at least one internal “brand czar” to be the ultimate arbiter on brand standards.

- Designation of Approved Suppliers. Another typical obligation that the franchisor undertakes is development of the franchise system supply chain via a network of approved or even exclusive suppliers of goods and services, which may include the franchisor or its affiliates, that franchisees may or must use in operating the franchised business. The purpose for restricting sources generally is to promote uniformity of the product and services offered to consumers. In addition, because of economies of scale, the franchisor may be able to negotiate more favorable pricing for the franchisees from various suppliers than each franchisee would be able to obtain individually. On the other hand, franchisees (particularly larger, multi-concept operators) may have existing relationships with alternative suppliers who the franchisees believe can provide similar goods or services on more favorable terms.

¹²⁹ See Chris Dull, Clint Ehlers, Andraya Frith & Max Staplin, *Ch-ch-ch-ch-changes: Implementing System Changes, Upgrades and New Directions under Existing Franchise Agreements*, IFA 50th Annual Legal Symposium (2017) at 11.

Practice Point. To promote smooth supply chain management, as well as the consistency of the customer experience at all system outlets, the franchisor should carefully develop internal policies for designating approved suppliers, which may include developing formal requests for information (RFIs) and requests for proposal (RFPs) that require suppliers to provide detailed information on product specifications (including samples), pricing, delivery terms, warranties, and other commercial terms.¹³⁰ The franchisor should also establish a process for reviewing requests by franchisees to approve alternative suppliers (a general summary of which it will need to disclose in Item 8 of the FDD). Finally, the franchisor should clearly communicate whether it will receive rebates, commissions, or other incentives from suppliers based on franchisee purchases – this is not just required to comply with disclosure requirements for Item 8 of the FDD but is also essential in fostering open communications and trust with the franchisee. And if feasible from an accounting and business perspective, the franchisor may wish to consider contributing all or a portion of any rebates or commissions to the marketing fund.

* * * * *

Practice Point. A franchisor should create pre-opening checklists to confirm that both the franchisee and franchisor have met all of their requirements before a new franchised outlet opens to the public. In addition, a franchisor should consider requesting that all franchisees sign a “Certificate of Compliance” indicating that the franchisor has met its pre-opening obligations. Finally, the franchisor should develop a system (whether via checklist or a more sophisticated customer relations management system) to track milestone requirements throughout the life of the franchise agreement, including additional training requirements, Convention attendance, compliance with local marketing requirements, quality assurance review results, and other events and obligations.

(2) New Brand Initiatives

As the startup franchisor gains experience, the system is likely to evolve, and the franchisor may introduce new or modified products and services in response to concerns or issues raised by franchisees and their customers, as well as to keep pace with industry trends and overall market conditions. Indeed, the startup franchisor must constantly monitor system performance to determine what’s working and what isn’t.¹³¹ Ultimately,

¹³⁰ See Joyce G. Mazero & Leonard H. MacPhee, *Setting the Stage for a ‘Best in Class’ Supply Chain*, 36 FRANCHISE L.J. 2, 221-224 (2016).

¹³¹ See, e.g., Ed Teixeira, *The State of Emerging Franchise Systems: Challenges and Opportunities, Part Two, Franchise Grade* (available at assets.franchisegrade.com/files/reports/analysis_of_emerging_franchises_2.pdf (“As franchise systems grow franchise leadership should be prepared and willing to adjust their franchise program. Too often, a floundering franchise is unwilling or incapable of making changes to their franchise, the result is wasting resources trying to sell a flawed system.”))

any new brand initiatives should be designed to add value both to the brand, as well as the franchisee's operations. For example, a quick-service restaurant franchisor that began on the West Coast may discover, based on customer and franchisee feedback that it is desirable to add grits to the breakfast menu as it expands to Southern states. Other franchisors may respond to changing consumer habits by moving from the drive-through to online ordering to apps or even delivery by drones or driverless cars.¹³²

Although larger and more established franchisors may have Research and Development ("R&D") or Innovation Departments with teams devoted to conducting market research and developing new products and services, many startup and smaller franchisees do not. To keep pace with industry trends and develop the system, startup and smaller franchisors may rely on experience at company-operated outlets, informal customer and franchisee feedback, competitor benchmarking, trade show, trade press, trade associations and other industry sources, franchisee advisory council recommendations, and/or outside consultants to assist with market research and product development.

Practice Point. Regardless of the process that the franchisor uses to develop a new brand initiative, the next step is determining how to implement it. One approach is to issue a mandate to the entire system and require compliance within a specified time period. Another, more measured approach is to beta-test the initiative at select company-operated and/or franchised locations. If the beta-testing yields positive results, then the franchisor will have a "proof of concept" to communicate to other franchisees before rolling out the new initiative system-wide. Finally, similar to other issues, clear communication to the franchisees of the what, how, and why of the new initiative is critical for gaining franchisee buy-in and adoption.¹³³

¹³² See, e.g., Tom Kaiser, *Pizza Hut Developing Fully Autonomous Delivery Vehicles with Toyota*, Franchise Times (Jan. 9, 2018), www.franchisetimes.com/news/January-2018/Pizza-Hut-Developing-Fully-Autonomous-Delivery-Vehicles-with-Toyota and Tom Kaiser, *Future's at Curb with Domino's, Ford Test*, Franchise Times (Oct. 10, 2017) www.franchisetimes.com/November-December-2017/Futures-at-curb-with-Dominos-Ford-test.

¹³³ See Dull, Ehlers, Frith & Staplin, *supra* note 129, at 15-17. See also *Stuller v. Steak 'N Shake Enterprises, Inc.*, 877 F. Supp. 2d 674 (C.D. Ill. 2012) (finding that franchise agreement was ambiguous regarding whether franchisor had the right to revise operational standards to require uniform pricing and promotions); *Nat'l Franchisee Ass'n v. Burger King Corporation*, No. 09-23435-CIV 2010 WL 4811912 (S.D. Fla. Nov. 19, 2010); Nathan, *supra* note 16, at 15-17 (identifying 14 tips for getting buy-in for change, including justification for the change, testing or piloting initiatives, consulting with franchisees, and others).

(3) Technology Modifications and Upgrades¹³⁴

Franchising has moved beyond electronic cash registers into cloud computing, mobile apps, and even A.I. With technology innovation progressing at a breathtaking pace, most franchisors can expect to make some modifications and upgrades to the franchise system's technology midstream – rather than at renewal only. Indeed, failure to keep up with the latest technology could pose an existential threat to the franchise system.¹³⁵ As a result, many franchisors use broad language in their franchise agreements that permit them to require franchisees to adopt new computer systems and other technology mid-term to keep pace with innovation.¹³⁶ In addition, before rolling out any new technology requirements and requiring franchisees to make substantial investments in new or different technology, the franchisor must research the technology and its impact on franchisees to provide the business case for the change and obtain franchisee buy-in before the planned change.¹³⁷

For a smaller franchisor without an IT department, keeping up with changes in technology may seem a daunting task; however, it is essential that the franchisor stay current with latest technology trends to improve the end-customer experience, franchise operations, and/or data security measures. The smaller franchisor may use a variety of methods to develop technology for the franchise system, including engaging an outside consultant, attending trade shows and otherwise monitoring technology trends, and consulting with franchisees (whether informally or through a franchisee advisory council or association).

¹³⁴ For more detailed discussion on modifying technology requirements, see Lorinda Church, Nancy Ghanem, Dominic Mochrie & Lee Plave, *Franchising and Technology: Staying Current and Managing Change*, IFA 44th Annual Legal Symposium (2011).

¹³⁵ See *Brenco Enterprises, Inc. v. Takeout Taxi Franchising*, Bus. Franchise Guide (CCH) ¶ 12,596, No. 177164 2003 WL 21659422 (Va. Cir. May 2, 2003) (not designated for publication); see also Ellen R. Lokker & Mark J. Loranger, *A Drama in Three Acts: How Takeout Taxi Franchisees Gained Their Independence*, 25 *FRANCHISE L.J.* 1, 11 (2005). Takeout Taxi was a food delivery concept developed in the late 1980s that used proprietary software to track orders and deliver services, but was perceived by its franchisees to be slow to adapt its technology to web-based services. Some franchisees became dissatisfied, about, among other things, the lack of technology enhancements.

¹³⁶ *Id.* at 24-25. Before mandating technology upgrades, the franchisor should review all existing franchise agreements to confirm that it has the authority to do so.

¹³⁷ *Id.*; see also *JDS Group LTD. V. Metal Supermarkets Franchising America, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,001, No. 17-cv-6293 2017 WL 2643667 (June 20, 2017); *LaQuinta Corp. v. Heartland Properties, LLC*, 603 F.3d 327 (6th Cir. 2010); *Bores, et al. v. Domino's Pizza, LLC*, Bus. Franchise Guide (CCH) ¶ 13,925, 530 F.3d 671 (8th Cir. 2008).

b. Enforcement of System Standards

All of the franchisor's efforts in developing and improving the franchise system and designing policies and procedures will be for naught if the franchisor fails to enforce system standards, permitting franchisees to operate subpar operations that damage the brand.¹³⁸ Failure to enforce standards may even lead to assertions by other franchisees that the franchisor breached an obligation to maintain "high and uniform standards."¹³⁹ At the same time, it generally is equally ill-advised for a franchisor to issue notices of defaults for every technical violation of the franchise agreement followed by a termination the day after the cure period expires.¹⁴⁰ Depending upon the nature of the default, the franchisor may find it more productive to counsel the franchisee, provide additional assistance or training, modify the franchise agreement, agree to a payment plan, agree to a mutual termination, or assist the franchisee in selling the franchise to a third party.¹⁴¹ The franchisor may even learn through the enforcement process that it had set unrealistic standards and may modify a system standard or maybe even a fee for all franchisees in the system.

To find the middle ground, franchisors should foster open communications with all franchisees and establish policies and procedures to address the following topics:

¹³⁸ Robert L. Zisk & Jeffrey L. Karlin, *Ongoing Operations Considerations*, COLLATERAL ISSUES IN FRANCHISING: BEYOND REGISTRATION AND DISCLOSURE, 337, 362 (Kenneth R. Costello ed., 2014).

¹³⁹ See Craig Tractenberg, Jean-Philippe Turgeon & Stéphanie Destrempe, *The Franchisor's Duty to Police the Franchise System*, 36 FRANCHISE L.J. 1, 91-92 (2016) (noting, however, that even if a court does find that the franchisor breached the franchise agreement by failing to enforce standards, damages are very difficult to prove). See also Lisa P. Storey, Jonathan Solish & Korin Neff, *Driving Compliance without Termination During an Economic Downturn*, IFA 42nd Annual Legal Symposium (2009).

¹⁴⁰ See *Quizno's Franchising II, LLC v. Zig Zag Restaurant Group, LLC, et al.* Bus. Franchise Guide (CCH) ¶ 14,046 (2008).

¹⁴¹ See Storey, Solish & Neff, *supra* note 139, at 12-21; see also John Gelson, Richard Hernandez & Jonathan Perez, *Practical Alternates to Termination*, IFA 50th Annual Legal Symposium (2017).

- Regular quality assurance reviews (“QAR”)
- Standardized QAR inspection forms
- Clear standards on what constitutes failure of the QAR
- Customer insight surveys (and clear communication to franchisees of how they will be used)¹⁴²
- Mystery shoppers
- Standardized forms to communicate quality assurance deficiencies and cures
- Formal default procedure (taking into account state franchise relationship laws)
- Re-inspection process
- Policies on recording and documenting communications with franchisees to create a paper trail

A startup or smaller franchisor may need to rely on outside counsel more heavily when addressing enforcement issues than a more established franchisor with an in-house legal department will. However, the startup or smaller franchisor generally can minimize legal costs by developing and following standard procedures in policing and enforcing system standards, such as documenting interactions with franchises, following a standard protocol for inspections and re-inspections, maintaining complete files, and avoiding impulsive emails.

c. Expansion – Too Rapid or Too Slow?

Another challenge for startup and small franchisors is system expansion. Too slow, and the franchise system may fail to develop critical mass and die on the vine (along with its unhappy franchisees).¹⁴³ On the other hand, if expansion is too rapid, the system may outgrow the franchisor’s financial, operational, and geographic reach, which may impair its ability to fulfill its obligations to its existing franchisees.¹⁴⁴ Rapid expansion can be especially problematic for undercapitalized franchisors that rely on initial fees to meet

¹⁴² See Ronald T. Coleman, Robert Einhorn & Jenny Winkler, *Fair or Foul? Use of Guest Surveys and Customer Feedback*, ABA 38th Annual Forum on Franchising (2015).

¹⁴³ Unhappy franchisees may even allege that the franchisor made fraudulent or negligent misrepresentations if actual system growth does not keep pace with promises made during the sales process or is grossly short of Item 20, Table No. 5 projections. See *Prof'l Shredding of Wis., Inc. v. ProShred Franchising Corp.*, Bus. Franchise Guide (CCH) ¶ 15,432, 2013 WL 9981203 (S.D.N.Y. Sept. 5, 2013) (finding that statements about future growth of the franchise system were “puffery”).

¹⁴⁴ See Fiorentino, Faunce & Seid, *supra* note 119, at 21.

operating costs, as they may succumb to the temptation to overlook franchisee qualification criteria and possibly even sales compliance in order to maintain a steady stream of initial fees.¹⁴⁵

An additional challenge for smaller and startup franchisors may be the lack of an established sales team to shepherd prospects from initial inquiry to the closing table. Although franchisee validation is an important step in the sales process for all franchisors, the validation process can be especially effective for startup and smaller franchisors who do not have a large footprint and name recognition. Existing, “early adopter” franchisees can be the best source of information for prospective franchisees and cheerleaders for the franchise system with several important caveats:

- A franchisor may not steer prospective franchisees toward existing franchisees who are likely to provide positive reviews, or away from existing, unhappy or struggling franchisees who are more likely to provide a negative review
- If an existing franchisee elects to discuss operational issues with a prospect (including earnings), that discussion will not be considered a financial performance representation, unless:
 - The franchisor scripts the discussion
 - The franchisee is acting as a referral source to the franchisor
- Franchisee testimonials can be very effective – just remember that a testimonial distributed by the franchisor is considered to be franchisor advertising. In other words, the franchisee cannot say anything in his or her testimonial that the franchisor would be prohibited from saying itself.

d. Nurturing Existing Franchisees

A final challenge for startup and smaller franchisors to consider before launching sales is development of a system to nurture its franchisees. Franchising is a symbiotic relationship, and the franchisor will not succeed, develop brand recognition, and expand the system without a core group of satisfied, successful franchisees to serve as “brand ambassadors.” Listening to and communicating with franchisees is essential and should be at the top of page 1 of any franchisor’s internal manual. Nurturing existing franchisees, however, may be even more important in startup or smaller franchise systems comprised primarily of single unit, “mom and pop” operators than it is in systems that target larger, multi-unit developers as franchisees.

Most startup franchisors will experience growing pains as the system develops, and as noted throughout this paper, will need franchisee buy-in and cooperation to implement programs, new brand initiatives, and technology upgrades, as well as to resolve disputes. Franchisors can create and foster positive relations with their franchisees by communicating regularly, listening to franchisee concerns (and carefully

¹⁴⁵ See Teixeira, *supra* note 131, at 11 (“Most importantly, franchisors shouldn’t assume they must sell 100 franchise locations as fast as possible to be successful.”)

documenting responses), establishing informal, “kitchen cabinet”- type advisors, and when sufficient critical mass has been reached, establishing or recognizing a franchisee advisory council or franchise association.¹⁴⁶ Franchisors that treat franchisees like rock stars at the closing table, and later ignore calls and emails requesting assistance may very well find themselves spending limited resources resolving informal disputes, system-wide rebellions and ultimately litigation.

5. Conclusion

This paper has attempted to highlight a number of the issues that startup and smaller franchisors may encounter as they develop, launch and grow their franchise programs, while recognizing the unique nature of the relationship between a franchisor and its franchisees. The franchisor should plan carefully and consider long-term objectives in structuring the franchise program and developing franchisee qualifications and sales compliance programs. A new franchisor also should consider working with seasoned professionals, such as franchise consultants and attorneys, to assist in developing its programs and documentation, including the FDD. Indeed, the preparation of initial investment estimates and financial performance representations is much an art as a science, and a new or smaller franchisor will be well-served to have an experienced advisor guide the franchisor through the various nuances and details. Finally, and perhaps most important, the franchisor should nurture and cultivate its existing franchisee relationships as the brand and franchise system continue to develop and evolve.

¹⁴⁶ See Harrison & Koch, *supra* note 3 at 15-16; see generally Roger Schmidt, Sr. & Harris J. Chernow, *Managing the Organization of a Franchise Association*, ABA 32nd Annual Forum on Franchising (2009).

APPENDIX A

SAMPLE CLOSING CHECKLIST FOR NEW FRANCHISE AGREEMENT

(The following is a sample closing checklist that identifies some of the key items that most franchise systems should review and verify before closing a new franchise deal, and which can be adapted as necessary to reflect the franchisor’s practices, as well as to account for other types of transactions (e.g., renewals, transfers, conversions, multi-unit development deals, etc.).

Franchisee Name: _____

Proposed Location (city/state if site not secured): _____

Document	Received (Y/N)	Date Received	Comments (if none, write “None”)
FDD Receipt (signed and dated by franchisee)			
Date Franchisee Received Complete Franchise Agreement (with blanks filled in)			
Signed Compliance Questionnaire or Disclosure Acknowledgment Statement (note any issues identified by prospective franchisee and how/when resolved)			
Signed Franchise Application			
Signed Franchise Agreement			
State-Specific Addendum to Franchise Agreement (if applicable)			
Other signed addenda (if applicable)			
Signed Guaranty			
OFAC Compliance			
Signed Lease or Deed (if applicable)			
Payment of Initial Franchise Fee (including date and method of payment)			

(continued on next page)

If Franchisee is an Entity
 (information shown for Corporations and LLCs only):

Document	Received (Y/N)	Date Received	Comments (if none, write "None")
<u>Corporation</u>			
• Articles of Incorporation			
• Bylaws			
• Stock Certificates			
<u>Limited Liability Company</u>			
• Certificate of Formation			
• Operating Agreement with list of Managing Members and Members (and % Ownership Interests)			
Authorizing Resolution			
Certificate of Good Standing			

APPENDIX B

FRANCHISEE DISCLOSURE ACKNOWLEDGEMENT STATEMENT

You are preparing to enter into Franchise Agreement with [NAME OF FRANCHISOR] (“Franchisor”). The purpose of this Questionnaire is to confirm that you understand the terms of the Franchise Agreement and that no unauthorized statements or promises have been made to you. Please review each of the following questions and statements carefully and provide honest and complete responses to each.

Franchise Applicant _____

- Yes ___ No ___ 1. Have you received and reviewed the [FRANCHISE CONCEPT] Franchise Disclosure Document (“FDD”) at least 14 calendar days, exclusive of the day you received it, before signing the Franchise Agreement and/or paying any monies to Franchisor?
- Yes ___ No ___ 2. Have you signed and returned to Franchisor the acknowledgment of receipt for each FDD given you?
- Yes ___ No ___ 3. Have you had an opportunity to read the Franchise Agreement and each of its attachments (and the Area Development Agreement if applicable) and each of its attachments thoroughly and understand all of Franchisor’s covenants and obligations and your covenants and obligations as a franchisee?
- Yes ___ No ___ 4. Do you understand that you and the employees that we designate must successfully complete and pass Franchisor’s management training program to Franchisor’s satisfaction before Franchisor will allow you to open the Franchised Business?
- Yes ___ No ___ 5. Do you understand that the territorial rights you have been granted are subject to limitations and exceptions? **[if applicable]**
- Yes ___ No ___ 6. Have you had an opportunity to consult with a lawyer, accountant, or other professional advisor prior to signing the Franchise Agreement (and the Area Development Agreement if applicable) or have you had the opportunity for such review and chosen not to engage such professionals?
- Yes ___ No ___ 7. Do you understand the risks of owning a business and specifically the risks of owning a [NAME OF FRANCHISE CONCEPT] franchise, and are you able to bear such risks?
- Yes ___ No ___ 8. Do you acknowledge that the success of your franchise will depend primarily on your own skills, efforts and abilities and those of the persons you employ as well as many factors beyond your or Franchisor’s control, including demographics, competition, local laws, lease terms, and other conditions which may be difficult or impossible to anticipate or identify may affect the success of your business?

- Yes ___ No ___ 9. Except for negotiated changes that have been initiated by you, did you receive a complete copy of the Franchise Agreement (and the Area Development Agreement if applicable) at least seven calendar days before the date on which you signed the Franchise Agreement (and the Area Development Agreement if applicable)?
- Yes ___ No ___ 10. Do you understand that all disputes or claims you may have arising out of or relating to the Franchise Agreement (and the Area Development Agreement if applicable) must be brought _____?
- Yes ___ No ___ 11. Do you agree that no employee or other person speaking on Franchisor's behalf made any statement or promise regarding the costs involved in operating a [NAME OF FRANCHISE CONCEPT] franchise that is not contained in the FDD or that is contrary to or different from, the information contained in the FDD?
- Yes ___ No ___ 12. Do you agree that no employee or other person speaking on Franchisor's behalf made any promises, guarantees or assurances to you and provided no information to you relative to earnings, revenues, profits, expenses or projected revenues for a [NAME OF FRANCHISE CONCEPT] franchise other than those contained in Item 19 of Franchisor's Franchise Disclosure Document?
- Yes ___ No ___ 13. Do you agree that no employee or other person speaking on Franchisor's behalf made any statement or promise or agreement, other than those matters addressed in your Franchise Agreement (and Area Development Agreement if applicable) concerning the advertising, marketing, media support, marketing penetration, training, support service, or assistance that is contrary to, or different from, the information contained in the FDD?
- Yes ___ No ___ 14. Do you understand that the Franchise Agreement and its attachments (and the Area Development Agreement and its attachments, if applicable) contain the entire agreement between Franchisor and you concerning the [NAME OF FRANCHISE CONCEPT] franchise, meaning any prior oral or written statements not set out in the Franchise Agreement (and the Area Development Agreement if applicable) will not be binding?
- Yes ___ No ___ 15. Do you understand that Franchisor is relying on your answers to this questionnaire to ensure that the franchise sale was made in compliance of state and federal laws?

If you answered "No" to any question above, please explain your response(s) below:

YOU UNDERSTAND THAT YOUR ANSWERS ARE IMPORTANT TO FRANCHISOR AND THAT FRANCHISOR WILL RELY ON THEM. BY SIGNING THIS QUESTIONNAIRE, YOU ARE REPRESENTING THAT YOU HAVE CONSIDERED EACH QUESTION CAREFULLY AND RESPONDED TRUTHFULLY TO THE ABOVE QUESTIONS.

FRANCHISE APPLICANT:

By: _____
Print Name: _____
Date: _____

APPENDIX C

SUMMARY OF STATE TIMING REQUIREMENTS TO AMEND FDD FOR MATERIAL CHANGE

State	Deadline to Amend
California	Promptly upon occurrence of any material change ¹⁴⁷
Hawaii	Before any further sales of the franchise ¹⁴⁸
Illinois	Within 30 days after the close of each fiscal quarter ¹⁴⁹
Indiana	N/A (no amendment filing is required)
Maryland	Promptly upon occurrence of any material change ¹⁵⁰
Michigan	Promptly notify state in writing of any change in the information contained in the original or amended notice submitted to state ¹⁵¹
Minnesota	Within 30 days after occurrence of any material change ¹⁵²
New York	Promptly upon occurrence of any material change ¹⁵³
North Dakota	Promptly upon occurrence of any material change ¹⁵⁴
Rhode Island	Promptly upon occurrence of any material change ¹⁵⁵
South Dakota	Within a reasonable time after the end of each quarter (however, no filing with the division is required) ¹⁵⁶

¹⁴⁷ CAL. CORP. CODE § 31123.

¹⁴⁸ HAW. REV. STAT. § 482E-3(b).

¹⁴⁹ 815 ILL. COMP. STAT. 705/11.

¹⁵⁰ MD. BUS. REG. § 14-220.

¹⁵¹ MICH. COMP. LAWS § 445.1519.

¹⁵² MINN. STAT. § 80C.07.

¹⁵³ N.Y. GEN. BUS. LAW § 683.9.

¹⁵⁴ N.D. CENT. CODE ANN § 51-19-07(6)(a).

¹⁵⁵ R.I. GEN. LAWS § 19-28.1-11.

¹⁵⁶ S.D. CODIFIED LAWS § 37-5B-7(2).

State	Deadline to Amend
Virginia	Within 30 days after occurrence of any material change ¹⁵⁷
Washington	As soon as reasonably possible after occurrence of any material change and before any further franchise sales ¹⁵⁸
Wisconsin	Within 30 days after the occurrence of any material change ¹⁵⁹

¹⁵⁷ 21 VA. ADMIN. CODE 5-110-40.

¹⁵⁸ WASH. REV. CODE § 19.100.70(3).

¹⁵⁹ WIS. STAT. § 553.31(1).

APPENDIX D

STATE REGISTRATION FEES

Registration State	Initial Filing Fee	Annual Renewal Filing Fee
California	\$675	\$450
Hawaii	\$250	\$250
Illinois	\$500	\$100
Indiana	\$500	\$250
Maryland	\$500	\$250
Michigan	\$250	\$250
Minnesota	\$400	\$300
New York	\$750	\$150
North Dakota	\$250	\$100
Rhode Island	\$600	\$300
South Dakota	\$250	\$150
Virginia	\$500	\$250
Washington	\$600	\$100
Wisconsin	\$400	\$400

If there is a material change to the franchise system, offering, or the franchisor during the year—even before the annual renewal is due—the registration states require that the franchisor file an amendment filing. The filing fees are between \$50 to \$250 per state for amendment filings.

APPENDIX E

SUMMARY OF STATE LAWS ON ESCROWS, BONDS AND DEFERRALS¹⁶⁰

State	Escrow	Bond	Deferral
California	Yes	Yes	Yes, informally
Hawaii	Yes	Yes	Not mentioned
Illinois	Yes	Yes	Yes
Indiana	Yes	Not mentioned	Not mentioned
Maryland	Yes	Yes	Yes
Michigan	Yes	Yes	Not mentioned
Minnesota	Yes	Yes	Not mentioned
New York	Yes	Yes	Not mentioned
North Dakota	Yes	Yes	Not mentioned
Rhode Island	Yes	Maybe as an alternative	Maybe as an alternative
South Dakota	Yes	Maybe as an alternative	Maybe as an alternative
Virginia	Yes	Not mentioned	Yes
Washington	Yes	Not mentioned	Not mentioned
Wisconsin	Yes	Yes	Not mentioned

¹⁶⁰ Noyes & Dosik, *supra* note 109, at 40.

APPENDIX F

PREVIOUS “TOP 10” PITFALL LISTS

Rocco Fiorentino, Marisa Faunce & Michael Seid, *Helping Franchise Systems Succeed: Avoiding the Pitfalls Encountered in the Early Stages of Franchising*, IFA 41st Annual Legal Symposium (2008).

1. Franchising Too Early
2. Undercapitalization
3. Failure to Seek Appropriate Professional Advice
4. Using Form Documents
5. Failing to Use the FDD to Showcase the Franchise System
6. Selecting the Wrong Franchisee for the Brand
7. Rapid Expansion Beyond Financial, Operational, and Geographic Means
8. Failing to Properly Define Protected Territories
9. Not Insisting on Adherence to Brand Standards
10. Not Knowing When to Negotiate the Franchise Agreement – Or Not

James Ullman & Melanie Bergeron, *Top 10 Pitfalls for Startup Franchisors*, IFA 44th Annual Legal Symposium (2011)

1. Franchising for the Wrong Reasons
2. Bringing on the Wrong Franchisee in the First Place
3. Failing to Get Proper Advice and Not Recognizing the Need for Experienced Franchise Professionals
4. Not Being Ready – Financially and Otherwise
5. Failing to Enforce Compliance and Failing to Keep Good Files/Records of Contact with Franchisees or Exercising Too Much Control
6. Failing to Protect Your Name and Logo Nationwide
7. Failure to Keep the Advertising Fund and Other Bank Accounts Separate
8. Failing to Establish a Strong Training Program and Failing to Measure or Validate Training Effectiveness
9. Failing to Reach out to Others for Best Practices and Failing to Reach Out to and Maintain Good Relationships with Franchisees
10. Failing to Have a Franchiseable, Sustainable and Teachable Concept