

# Does Your Square Peg Not Fit into a Round Hole? Consider the Discretionary Exemption

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Compliance with state franchise registration and disclosure laws<sup>1</sup> can be expensive and time consuming. As such, putative franchisors and franchisors alike often seek to identify an exemption or exclusion from the applicable law in hopes of being able to avoid the registration and disclosure provisions of the law.



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Unfortunately, sometimes the proposed franchisor or franchise transaction does not fit into a typical exemption, or the state lacks an applicable exemption. But one exemption, often trailing at or near the bottom of a state's list of exemptions—and often overlooked—is the so-called “discretionary exemption,” an exemption in the public interest, or exemption by order or rule. This exemption permits a state regulatory agency<sup>2</sup> to exempt an offer for sale or sale of a franchise from certain parts of the state's registration or disclosure requirements upon a written request for an administrative order for exemption, provided that (1) the proposed transaction is not within the purposes of the state's franchise law; and (2) registration or disclosure of the transaction is not necessary in the public interest or for the protection of prospective franchisees. The discretionary exemption is an often-ignored exemption from registration or disclosure, perhaps because of its vague requirements or patchwork application. However, the discretionary exemption can be a useful fallback

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1. California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Washington, Virginia, and Wisconsin are referred to as franchise registration states. Of course, the client would also need to comply with the federal franchise disclosure law, 16 C.F.R. pt. 436.

2. As used in this article, “state regulatory agency” means the state agency overseeing franchise registration and disclosure (often the state's Attorney General or Department of Commerce or Securities).

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for practioners and franchisors if no other exemption applies; for certain transactions, the discretionary exemption can even be the initial strategy to avoid registration or disclosure requirements in a particular state.

This article first provides an overview of the general characteristics of the discretionary exemption,<sup>3</sup> followed by a more detailed review of the various types of discretionary exemptions existing in various states. The article then demystifies the discretionary exemption with practical considerations for franchise attorneys and franchisors if they plan to rely on employing a discretionary exemption strategy in connection with the offer or sale of franchises.

## I. Registration and Disclosure Framework

Before a franchise can be offered for sale or sold in any state, the franchisor must provide its current franchise disclosure document to a prospective franchisee. Further, in fourteen registration states, a franchisor must first register its franchise disclosure document with the respective state regulatory agencies before making any offers for sale or sales of franchises in the states. But a franchisor's proposed offer or sale, or the franchisor in general, may be exempt from complying with certain parts of the state's registration or disclosure requirements. Exemptions vary state-by-state.<sup>4</sup>

## II. Overview of Discretionary Exemptions

Thirteen of the fourteen registration states provide for some variation of the discretionary exemption: California,<sup>5</sup> Hawaii,<sup>6</sup> Illinois,<sup>7</sup> Indiana,<sup>8</sup> Maryland,<sup>9</sup> Michigan,<sup>10</sup> Minnesota,<sup>11</sup> New York,<sup>12</sup> North Dakota,<sup>13</sup> Rhode Island,<sup>14</sup>

3. Note that many state franchise laws also permit the state regulatory agency to deny or revoke any statutory exemption, such as the sophisticated investor or large franchisor exemption, if in the public interest, and certain hearing processes are followed. *E.g.*, IND. CODE § 23-2-2.5-6 (2018); WIS. STAT. § 553.24(2) (2018). This article focuses on the discretionary exemption from registration or disclosure requirements only. Business opportunity laws are also beyond the scope of this article.

4. See ABA FORUM ON FRANCHISING, EXEMPTIONS AND EXCLUSIONS UNDER FEDERAL AND STATE FRANCHISE REGISTRATION AND DISCLOSURE LAWS 128 (Leslie D. Cuitan & Beata Krakus eds., 2017) [hereinafter, EXEMPTIONS AND EXCLUSIONS].

5. CAL. CORP. CODE § 31100.

6. HAW. REV. STAT. § 482E-4(b); see also *infra* Part III.A.

7. 815 ILL. COMP. STAT. 705/9; ILL. ADMIN. CODE. tit. 14, § 200.201; see also *infra* Part III.B.

8. IND. CODE §§ 23-2-2.5-5, 23-2-2.5-8; see also *infra* Part III.C.

9. MD. BUS. REG. CODE § 14-214(b)(3); MD. COMAR 02.02.08.10(G); see also *infra* Part III.D.

10. See *infra* Part III.E.

11. MINN. STAT. § 80C.03(g); see also *infra* Part III.F.

12. N.Y. GEN. BUS. LAW § 684(1)-(2); see also *infra* Part III.G.

13. N.D. CENT. CODE § 51-19-04(3); see also *infra* Part III.H.

14. R.I. GEN. LAWS § 19-28.1-6(10); see also *infra* Part III.I.

South Dakota,<sup>15</sup> Virginia,<sup>16</sup> and Wisconsin.<sup>17</sup> Washington State does not provide for a discretionary exemption.<sup>18</sup> The reason legislatures have delegated discretion to state regulatory agencies to exempt certain transactions from registration or disclosure requirements is to transfer oversight responsibility to nimble administrative agencies that have more expertise than a state legislature in a specific area.<sup>19</sup> The purpose of franchise registration and disclosure laws is to protect prospective franchisees by requiring franchisors to provide detailed disclosures before they purchase a franchise. Sometimes, however, a state regulatory agency may conclude that such protection is not necessary or that a franchisor need only comply with a portion of its state's franchise law, without undermining the purpose of the franchise law.

Although each of these thirteen states permits the state regulatory agency to exempt certain franchise transactions from parts of the state's registration or disclosure requirements, the criteria for granting the exemption and what is specifically exempted differ in each jurisdiction.<sup>20</sup> Navigating the discretionary exemption can therefore be difficult or unreliable especially considering that, by its definition, the state regulatory agency has wide latitude to grant or deny the discretionary exemption.

The discretionary exemption can be categorized into two types: discretionary exemption by order (or upon request) and discretionary exemption by rule.

#### A. Discretionary Exemptions by Order

A franchisor can request an exemption from registration or disclosure requirements in a state, and the state regulatory agency can grant or deny such request via the issuance of an order in its discretion (subject to some

15. S.D. CODIFIED LAWS § 37-5B-15.

16. VA. CODE § 13.1-560; *see also infra* Part III.I.

17. WIS. STAT. § 553.25; *see also infra* Part III.J.

18. EXEMPTIONS AND EXCLUSIONS, *supra* note 4, 1-20, 235.

19. IND. CODE § 23-2-2.5-47; *Quist v. Best Western Int'l., Inc.*, 354 N.W.2d 656, 660 (N.D. 1984) ("The administration of the [state franchise law] is an area where there is an obvious need for agency expertise. The statutory scheme provided in the [state franchise law] is common to such situations where the Legislature cannot be expected to provide for regulation of the public interest on a case-by-case basis.")

20. Various attempts have been made to create a uniform discretionary exemption. The Model Franchise Investment Act, Bus. Franchise Guide (CCH) ¶ 3700 § 6(k) (Aug. 30, 1990), includes a prehistoric discretionary exemption similar to Minnesota's version. Over time, the North American Securities Administrators Association (NASAA) has modernized the discretionary exemption with details on the process to request an order. NASAA issued updated, proposed model franchise exemptions on June 30, 2011 for states to adopt to create uniformity across states requiring registration and disclosures for franchises. NASAA, NASAA PROPOSED MODEL EXEMPTIONS 9 (June 30, 2011). NASAA invited comments on the proposed model franchise exemptions, before issuing its final model franchise exemptions on September 9, 2012. The final model discretionary exemption is similar to most states' exemptions with some variations (in particular, the model discretionary exemption includes information on applying for a discretionary exemption that is absent in most state franchise laws). NASAA, NASAA MODEL FRANCHISE EXEMPTIONS 9-10 (Sept. 9, 2012).

limitations). The franchise laws of Hawaii,<sup>21</sup> Illinois,<sup>22</sup> Indiana,<sup>23</sup> Maryland,<sup>24</sup> Michigan,<sup>25</sup> Minnesota,<sup>26</sup> New York,<sup>27</sup> North Dakota,<sup>28</sup> Rhode Island,<sup>29</sup> South Dakota,<sup>30</sup> Virginia,<sup>31</sup> and Wisconsin<sup>32</sup> permit the state regulatory agency to grant a discretionary exemption by order upon the request of a franchisor. An “order” means a consent, authorization, or prohibition issued by a state regulatory agency specific to a certain case, whether or not at the request of a franchisor.<sup>33</sup>

### 1. The Three P’s: Public Interest, Protection, and Purpose

In most states, a transaction (such as an offer or sale of a franchise) is exempt from certain registration or disclosure requirements if the state regulatory agency finds that (1) a proposed transaction is not within the purposes of the state’s franchise law (the Purpose Condition); and (2) registration or disclosure of the transaction is not necessary in the public interest (the Public Interest Condition) or for the protection of prospective franchisees (the Protection Condition).<sup>34</sup> A few states, notably Hawaii, Illinois, Michigan, and Virginia, vary the conditions more significantly,<sup>35</sup> and Illinois, New York, Rhode Island, South Dakota, and Wisconsin do not statutorily require the Purpose Condition.<sup>36</sup>

#### (a) *The Purpose Condition*

Generally speaking, the purpose of state registration and disclosure laws is to provide prospective franchisees with the information necessary to make an informed decision regarding the investment opportunity, to prohibit

21. HAW. REV. STAT. § 482E-4(b).

22. 815 ILL. COMP. STAT. 705/9.

23. IND. CODE § 23-2-2.5-5.

24. MD. BUS. REG. CODE § 14-214(b)(3); MD. COMAR 02.02.08.10(G).

25. MICH. COMP. LAWS §§ 445.1501-1546.

26. MINN. STAT. § 80C.03(g).

27. N.Y. GEN. BUS. LAW § 684(2); EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 158–59. Note that while New York law states that a discretionary exemption by “rule or regulation” is available, the authors and New York practitioners have requested discretionary exemptions by order. EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 158–59.

28. N.D. CENT. CODE § 51-19-04(3); EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 173–74. Note that while North Dakota law states that a discretionary exemption by rule is available, North Dakota practitioners appear to have requested discretionary exemptions by order. EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 173–74.

29. R.I. GEN. LAWS § 19-28.1-6(10).

30. S.D. CODIFIED LAWS § 37-5B-15.

31. VA. CODE § 13.1-560.

32. WIS. STAT. § 553.25.

33. *E.g.*, 815 ILL. COMP. STAT. 705/3(6); MINN. STAT. § 80C.01, subd. 11; MICH. COMP. LAWS 445.1503(4).

34. *E.g.*, CAL. CORP. CODE § 31100; IND. CODE § 23-2-2.5-5; MD. BUS. REG. CODE § 14-214(b)(3) (for discretionary exemptions by rule); MD. COMAR 02.02.08.10(G) (for discretionary exemptions by order); MINN. STAT. § 80C.03(g); N.D. CENT. CODE § 51-19-04(3).

35. See *infra* Part III.

36. 815 ILL. COMP. STAT. 705/9; N.Y. GEN. BUS. LAW § 684(1); R.I. GEN. LAWS § 19-28.1-6(10); S.D. CODIFIED LAWS § 37-5B-15; WIS. STAT. § 553.25.

fraudulent sales of franchises, and to protect the franchisor-franchisee relationship via disclosures.<sup>37</sup> Franchise registration and disclosure laws attempt to satisfy this purpose by requiring the franchisor to provide the prospective franchisee with detailed information regarding the investment opportunity.<sup>38</sup> In one case, the Indiana Court of Appeals provided an example, in dicta, of an offer or sale of a franchise that is within the purposes of Indiana's franchise law and where disclosure is necessary to protect a prospective franchisee. Specifically, in *Continental Basketball Ass'n v. Ellenstein Enterprises, Inc.*,<sup>39</sup> the court held that where a franchisor is inadequately capitalized and is using the sales of franchises (and associated franchise fees) as its primary funding source, a franchisee is essentially contributing equity to the franchisor. The court continued: "Under these circumstances, the risks are akin to those posed by an investment in securities and are plainly intended to be the subject of the Act's disclosure provisions . . . ."<sup>40</sup> Of course, given the broad scope of state franchise laws, the more difficult challenge is finding a transaction that is beyond its purview to satisfy the Purpose Condition.

(b) *The Public Interest Condition*

The Public Interest Condition is very similar to the Purpose Condition in that the purpose of state franchise laws is to protect the public from deceptive investment opportunities. Indeed, courts have interpreted "public interest" within the confines of the purpose of the law at issue. For example, in *People v. Carter*,<sup>41</sup> the Illinois Supreme Court agreed with the Appellate Division of the Supreme Court of New York that the term "public interest," standing alone, presents a standard of immense and varied implications . . . . [But] it should be construed with reference to the general purposes and the subject matter of the [law in question] . . . ."<sup>42</sup> Thus, the Public Interest Condition should be construed together with the Purpose Condition.

(c) *The Protection Condition*

Alternatively, state regulatory agencies are more inclined to grant a discretionary exemption upon a finding that registration or disclosure of a transaction is not necessary for the protection of prospective franchisees. For example, where the information contained in a disclosure statement is readily available through other sources, a state regulatory agency may "find

37. See generally, CAL. CORP. CODE § 31001; HAW. REV. STAT. § 482E-1; MD. BUS. REG. CODE § 14-202; N.Y. GEN. BUS. LAW § 680(1); R.I. GEN. LAWS § 19-28.1-2; In the Matter of Crd Enter. Inc. d/b/a Jan-Pro Cleaning Sys. of So. New England, D.B.R. No. 10-S-0112 (R.I. Dep't of Bus. Reg. June 7, 2011).

38. See R.I. GEN. LAWS § 19-28.1-2.

39. Continental Basketball Ass'n v. Ellenstein Enters., Inc., 640 N.E.2d 705 (Ind. Ct. App. 1994), *aff'd*, 669 N.E.2d 134 (1996).

40. *Id.* at 710-11.

41. *People v. Carter*, 454 N.E.2d 189, 190-91 (Ill. 1982) (citing *Int'l Ry. Co. v. Pub. Serv. Comm'n*, 264 A.D. 506 (N.Y. App. Div. 1942)); see also *Am. Power & Light Co. v. Sec. & Exch. Comm'n*, 329 U.S. 90, 104 (1946) (holding same).

42. *Carter*, 454 N.E.2d at 190-91.

that enforcement of the [state's franchise law] is not necessary."<sup>43</sup> The Protection Condition could also be satisfied if the franchisor has a high net worth and a history of franchising or operating outlets (but a particular state does not have the large franchisor exemption or, due to some technicality, the franchisor does not meet the exact requirements of the large franchisor exemption).<sup>44</sup>

If a prospective franchisee is sophisticated or has experience in the franchise system, a franchisor could also argue that the prospective franchisee does not need the protection of the franchise laws. The discretionary exemption could be useful for renewing an existing franchise.

(d) *Interplay of the Conditions*

A request by a franchisor for an order exempting a transaction should identify why the franchise offering does not need to be registered or why the transaction should require only certain disclosures based on the appropriate conditions. A franchisor should address all three conditions regardless of the specified conditions in a particular state because the conditions must be construed together. The state regulatory agency has the final say on whether the conditions are satisfied.

The fact that Hawaii, Illinois, New York, Rhode Island, South Dakota, and Wisconsin do not require a franchisor to satisfy the Purpose Condition is irrelevant in practice. Given the similarities between the three conditions, a prudent franchisor should always address the Purpose Condition in any request for a discretionary exemption. In particular, if a franchisor requests a discretionary exemption based on the Public Interest Condition, the franchisor should still specify why registration or disclosure (as applicable) is not within the purview of the state's franchise law with reference to the franchise law's statutory purpose (even if the state franchise law does not list the Purpose Condition as in these six states). Likewise, because the primary purpose of state franchise laws is to protect prospective franchisees with adequate disclosures, a franchisor claiming that registration or disclosure is not necessary for the protection of a prospective franchisee should also state why the transaction is beyond the purposes of the franchise law. The facts and reasoning may be the same under each condition given the fuzzy distinction between them.

43. *Id.* at 191.

44. For example, in the authors' experience, a large franchisor was able to rely on its unaudited financial statements given the history of the franchisor, size of the franchise system, and the franchisor's (unaudited) net worth, without having audited financial statements that would have otherwise met New York's large franchisor exemption. See *infra* Part IV.B. In another instance, the authors were able to claim discretionary exemptions in a number of states to allow a newly-formed and well-capitalized franchisor entity of a franchise system with thousands of locations to rely on its predecessor's experience because the franchisor and the predecessor had the same ownership and management, despite the fact that large franchisor exemptions typically require the "franchisor" meet the experience requirement.

## 2. Overlap with Other Exemptions

Many of the transactions that fall outside the scope of a state's franchise laws, and hence could be exempt under a discretionary exemption as not within its purposes, are already exempt under other, more definite exemptions. This overlap arises because the intent behind all exemptions is to exempt franchise offers or sales that are low-risk (e.g., because of the aptitude of the prospective franchisee, a low initial investment, or the operational size, stability, and experience of the franchisor). For example, several states exempt from their registration and disclosure requirements transactions between parties to existing franchise relationships and transactions with sophisticated investors. These transactions would arguably fall outside the purpose of the registration and disclosure requirements as the existing franchisee (or prospective franchisee) does not necessarily need protection as it is already familiar with the franchise system or is an experienced franchisee capable of understanding the investment risks involved.

Another example of this situation is those transactions that involve de minimis amounts. For example, Maryland exempts the registration of the offer or sale of a franchise where the franchise fee does not exceed \$100 annually, finding that such a low-risk transaction is "not within the purpose of the Maryland Franchise [Registration and Disclosure] Law and registration of the transaction[] is not necessary or appropriate for the protection of investors."<sup>45</sup> Registration of this transaction would probably also be exempt under the state's discretionary exemption by order because it meets the state's conditions (even if the Office of Attorney General did not specifically codify this). Similarly, Illinois law confirms that enforcement of its Franchise Disclosure Act of 1987 is not necessary on a case-by-case basis depending on the investment involved.<sup>46</sup> An offer or sale of a franchise to an existing franchisee is already exempt in many states, but could also be a good candidate for a discretionary exemption because the existing franchisee is already familiar with the franchise system. In this regard, the utility of the discretionary exemption is considerably limited as its applicability is covered by other exemptions; nonetheless, the discretionary exemption can be useful in certain situations as discussed later in Part IV.

## 3. Exempt Registration or Disclosure Requirements

State registration obligations require a franchise be registered with the state regulatory agency. State disclosure obligations require a franchisor to provide prospective franchisees with franchise disclosure documents. So,

45. MD. COMAR. 02.02.08.10(C). The Maryland Office of the Attorney General has by rule stated that registration and disclosure is not necessary for the protection of potential franchisees in these types of transactions involving small franchise fees or made to seasoned franchisees, sophisticated franchisees, or institutional franchisees. *Compare* MD. BUS. REG. CODE § 14-214(b)(3) (authorizing the state regulatory agency to issue new exemptions by rule if they are in the public interest and not necessary to protect prospective franchisees), *with* MD. COMAR 02.02.08.10(B-G) (promulgating the typical exemptions available in most other states).

46. 815. ILL. COMP. STAT. 705/9.

from what statutory requirements is a franchisor specifically exempted under a discretionary exemption?

The Hawaii Director of Commerce and Consumer Affairs is permitted to discretionarily exempt a franchisor from only its franchise disclosure document requirements (including the filing, delivering, amending, and renewals thereof), sales recordkeeping requirements, and automatic consent to jurisdiction in the state and agent for service of process.<sup>47</sup> Indiana provides an exemption from registering and delivering disclosure statements.<sup>48</sup> Illinois<sup>49</sup> and Maryland<sup>50</sup> provide an exemption from registration only, unless the state regulatory agency determines otherwise. Michigan's discretionary exemption is perhaps the most unique, but very limited in its applicability, providing an exemption from filing audited financial statements and employing franchise agents on exclusive terms.<sup>51</sup> Minnesota,<sup>52</sup> North Dakota,<sup>53</sup> New York,<sup>54</sup> South Dakota,<sup>55</sup> and Wisconsin<sup>56</sup> provide an exemption from registration and disclosure.

The discretionary exemptions available in Rhode Island<sup>57</sup> and Virginia<sup>58</sup> have significantly less utility because their respective state regulatory agencies are only permitted to exempt a transaction from their registration requirements. A franchisor should consider whether simply registering in these states may be less time-consuming than seeking a discretionary exemption.

The discretionary exemption may not be useful in notice filing states or states that do not review the contents of the franchise disclosure document. Specifically, Indiana, Michigan, South Dakota, and Wisconsin simply require a franchise application before offering or selling franchises in those states. These states will not review the contents of the franchise disclosure document. If a franchisor already has a current franchise disclosure document in compliance with federal law, it is typically easier and quicker to file the franchise applications in these states than it is to request a discretionary exemption (which requires review from the state regulatory agency). Registration is effective in these states upon receipt of the franchise application.

47. HAW. REV. STAT. § 482E-4(b); EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 58–59.

48. IND. CODE § 23-2-2.5-5; EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 89–90.

49. ILL. ADMIN. CODE tit. 14, § 200.201.

50. MD. BUS. REG. CODE § 14-214(b); MD. COMAR 02.02.08.10.

51. *See infra* Part III.E.

52. MINN. STAT. § 80C.03(g); EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 115.

53. N.D. CENT. CODE §§ 51-19-08(3), 51-19-04(3); EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 173–74.

54. N.Y. GEN. BUS. LAW § 684(1); EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 158–59.

55. S.D. CODIFIED LAWS § 37-5B-15; EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 203–04. South Dakota law also provides an exemption from having to notify prospective franchisees when amending franchise agreements or disclosure documents, and having to include all information required under state law in disclosure documents as prepared for prospective franchisees. *Id.*

56. WIS. STAT. § 553.25; EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 249–50.

57. R.I. GEN. LAWS §§ 19-28.1-6 and 19-28.1-8; EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 189–90.

58. VA. CODE § 13.1-560; EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 217–18.

Of course, even if state law provides an exemption from registration and disclosure, a franchisor must still comply with the federal franchise law requiring disclosure of a franchise disclosure document to prospective franchisees, unless a federal exemption applies as well. No discretionary exemption exists at the federal level, so a franchisor would need to find another federal exemption if it wants to avoid disclosure requirements. Discretionary exemptions will not exempt a franchisor from other provisions of state law, especially anti-fraud provisions and franchise relationship laws.

### B. *Discretionary Exemptions by Rule*

Many state franchise laws also permit the state regulatory agency to promulgate administrative regulations creating additional exemptions for transactions under the discretionary exemption, provided that registration or disclosure regarding the transaction is not necessary (1) under the state's franchise law; and (2) in the public interest or for the protection of prospective franchisees. The franchise laws of the following states permit their respective state regulatory agency to create additional exemptions by rule: California,<sup>59</sup> Hawaii,<sup>60</sup> Illinois,<sup>61</sup> Indiana,<sup>62</sup> Maryland,<sup>63</sup> Minnesota,<sup>64</sup> New York,<sup>65</sup> North Dakota,<sup>66</sup> Rhode Island,<sup>67</sup> South Dakota,<sup>68</sup> Virginia,<sup>69</sup> and Wisconsin.<sup>70</sup> Of these states, the franchise laws of California and North Dakota appear only to authorize their state regulatory agencies to grant discretionary exemptions by rule (and not necessarily by order) based on the plain reading of each state's franchise law. Whereas most discretionary exemptions explicitly provide for an exemption by order or rule, the phrase "by order" is absent from California's and North Dakota's discretionary exemption.<sup>71</sup> The absence of "by order," however, does not necessarily preclude a franchisor from still requesting the California Department of Business Oversight or North Dakota Securities Commissioner pass a new regulation exempting a transaction or issue an interpretive order.<sup>72</sup> Further, the North Dakota

59. CAL. CORP. CODE § 31100.

60. HAW. REV. STAT. § 482E-4(b).

61. 815 ILL. COMP. STAT. 705/9.

62. IND. CODE § 23-2-2.5-5.

63. MD. BUS. REG. CODE § 14-214(b)(3).

64. MINN. STAT. § 80C.03(g).

65. N.Y. GEN. BUS. LAW § 684(1).

66. N.D. CENT. CODE § 51-19-04(3).

67. R.I. GEN. LAWS § 19-28.1-6(10).

68. S.D. CODIFIED LAWS § 37-5B-15.

69. VA. CODE § 13.1-560.

70. WIS. STAT. § 553.25.

71. CAL. CORP. CODE § 31100 ("There shall be exempted . . . any other transaction which the commissioner by rule exempts . . ."); N.D. CENT. CODE § 51-19-04(3) ("There must be exempted from the provisions of section 51-19-03 [registration] any other transaction which the commissioner by rule exempts . . .").

72. See, e.g., *Quist v. Best Western Int'l, Inc.*, 354 N.W.2d 656 (N.D. 1984) (refusing to issue an interpretative opinion pursuant to its discretionary exemption by rule power to exempt a transaction).

Securities Commissioner is still authorized to issue orders to administer the state's Franchise Investment Law.<sup>73</sup>

Several state regulatory agencies have issued additional exemptions by rule under the discretionary exemption. Notably, the Maryland Office of the Attorney General has only one legislative exemption: the discretionary exemption, under which the Attorney General can promulgate additional exemptions by rule. The Maryland Attorney General has in fact promulgated similar exemptions as available in other states under its discretionary power (and has also permitted discretionary exemptions by order).<sup>74</sup> The Illinois Attorney General exempts by rule certain franchise trade show promoters, as well as isolated transactions arising from referral sources and certain large franchisors, from complying with portions of the Illinois Franchise Disclosure Act of 1987.<sup>75</sup> The New York Department of Law likewise exempted by rule the offer for sale (but not the sale) of franchises at International Franchise Expos to ensure that franchisors not registered in the state could participate in the expos.<sup>76</sup> Further, New York does not require that the offer or sale of a franchise, where the franchise involves adding a new product or service line to an existing business of a prospective franchisee, be registered in certain cases pursuant to an administrative rule.<sup>77</sup> Internet offers of franchises and online franchise advertising (but not the actual sale) are exempt by rule in several states. The North Dakota Securities Commissioner exempts by rule the offer or sale of a franchise organized as a nonprofit corporation for the use of its own members.<sup>78</sup> The Virginia State Corporation Commission<sup>79</sup> and the Wisconsin Division of Securities<sup>80</sup> exempt by rule several transactions, such as those with institutional or existing franchisees.

### III. State-Specific Requirements for Requesting an Exemption

The process to request a discretionary exemption, conditions for receiving a discretionary exemption, and the registration or disclosure requirements that may be exempt under the discretionary exemption vary state-by-state. Careful compliance with the terms of each discretionary exemption is therefore critical. Highlighted below are some of the material nuances to the general rules provided earlier.

73. Syver Vinje, N.D. Sec. Comm'r, Nov. 29, 2000, Bus. Franchise Guide (CCH) ¶ 5340.02.

74. See *supra* note 45.

75. ILL. ADMIN. CODE tit. 14, § 200.202.

76. E.g., Barbara D. Underwood, Office of Att'y Gen., State of N.Y. Dep't of Law, Pursuant to § GBL 684(1), Exemption Request for an Unregistered Franchisor to Exhibit and Offer for Sale, But Not to Sell, Franchises at the International Franchise Expo in New York (May 2019).

77. N.Y. COMP. CODES R. & REGS. tit. 13, § 200.10(2).

78. N.D. ADMIN. CODE 73-03-01-01.

79. 21 VA. ADMIN. CODE § 5-110-75.

80. WIS. ADMIN. CODE D.F.I. § 32.05.

### A. Hawaii

Hawaii's discretionary exemption is similar to most states' discretionary exemptions, except that it has a unique condition for when the Hawaii Director of Commerce and Consumer Affairs can grant an exemption. The Hawaii Director of Commerce and Consumer Affairs may grant a discretionary exemption based on (1) whether the information that would be required to be disclosed in a franchise disclosure document is material to a prospective franchisee "in determining whether the prospective franchisee has a reasonable chance of success;" and (2) if the discretionary exemption is within the public interest.<sup>81</sup>

To elaborate on the materiality condition, the state's franchise law restates its aim to protect the public interest by furnishing prospective franchisees the information necessary to make an investment decision.<sup>82</sup>

### B. Illinois

Illinois has the most developed—i.e., the least discretionary—discretionary exemption. Illinois's discretionary exemption has unique qualifiers. Further, the Illinois Franchise Disclosure Act of 1987 provides significant detail on how a franchisor can request an exemption.

The Act gives the Attorney General the power to grant a discretionary exemption from registration if it finds that enforcement of the Act is not necessary: (1) in the public interest; (2) for the protection of prospective franchisees; (3) because of the investment involved; or (4) in a limited offering "because of the limited character of the offering."<sup>83</sup> Regulation of the offer or sale of a franchise is not within the public interest (and hence, may be discretionarily exempt) if (1) the franchisor intends to sell only one or two franchises in the state within a twelve month period; (2) litigation and bankruptcy disclosures are not materially adverse to the prospective franchisee; (3) the franchisor timely provides the prospective franchisee with a franchise disclosure document; and (4) the franchisor obtains a consent letter<sup>84</sup> from the prospective franchisee's attorney.<sup>85</sup>

81. HAW. REV. STAT. § 482E-4(b).

82. *Id.* § 482E-1(b).

83. 815 ILL. COMP. STAT. 705/9.

84. The franchisor must obtain a letter from the prospective franchisee's attorney, *after* issuance of the discretionary exemption but within the fourteen-day time periods described in 815 ILL. COMP. STAT. 705/5(2), stating that the attorney has explained the Franchise Disclosure Act of 1987 to the prospective franchisee client and that the client has not objected to the issuance of the discretionary exemption. The franchisor must forward this consent letter to the Illinois Attorney General. Note that during the lay period (after the discretionary exemption is granted but before the franchisor obtains the consent letter), the franchisor may only solicit prospective franchisees but may not sign any contract or require any prospective franchisee or subfranchisor to pay consideration. ILL. ADMIN. CODE tit. 14, § 200.201.

85. ILL. ADMIN. CODE tit. 14, § 200.201; EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 74.

A franchisor must submit the following to be considered for a discretionary exemption: (1) a cover letter;<sup>86</sup> (2) a franchise disclosure document; (3) a list showing all franchise sales in Illinois since the most recent franchise disclosure document that is submitted with the exemption application; and (4) a certification page.<sup>87</sup> Based on the requirements of the cover letter (which require, *inter alia*, disclosure of other registration states and the Federal Trade Commission that have issued or denied exemptions or furnished opinions thereto), it may be advisable for a franchisor to request an Illinois discretionary exemption after the franchisor has been registered in other registration states or has been exempted under an exemption to further bolster why it should be granted an Illinois exemption.

### C. Indiana

Indiana is a state that requires the franchisor to meet the Purpose Condition, Public Interest Condition, and Protection Condition. A franchisor must submit all material facts relating to the proposed offer or sale, along with a request for a ruling on the exemption claimed, and a \$50 filing fee.<sup>88</sup>

Indiana provides an exemption from registering and delivering disclosure statements.<sup>89</sup> Because of the relative ease in registering a franchise offering in Indiana (Indiana does not review the contents of the franchisor's franchise disclosure document), if a franchisor has a current franchise disclosure document it uses in other states, it is arguably easier to file a franchise application in Indiana than seek out an exemption.<sup>90</sup> However, if a franchisor does not have a current franchise disclosure document, the discretionary exemption may save time and money in preparing one. Since Indiana lacks published guidelines pertaining to a timeline for when an exemption may be granted, and the standards used to evaluate the request, it seems likely that if a franchisor receives an exemption under federal law, or a different state law, it has a reasonable chance of being granted one in Indiana.

### D. Maryland

Like Illinois' discretionary exemption, Maryland's franchise act also details how a franchisor can specifically request a discretionary exemption by order. A franchisor must file a request for an order exempting the offer or sale

86. The cover letter must (1) describe the basis for the exemption by reference to ILL. ADMIN. CODE tit. 14, § 200.201(a) and 815 ILL. COMP. STAT. 705/9 (see *supra* text accompanying notes 83); (2) list any other franchise regulatory states and the Federal Trade Commission that have issued or denied exemptions or opinions, together with copies of the exemptions or opinions; and (3) state the number of franchises the franchisor intends to sell in Illinois in the next twelve months. ILL. ADMIN. CODE tit. 14, § 200.201(a)(1).

87. A form certification page is available at ILL. ADMIN. CODE tit. 14, § 200 App. A, Illus. G.

88. IND. CODE § 23-2-2.5-8. The Commissioner may deny an exemption from registration and disclosure requirements if there has been failure to comply with the provisions of this chapter, or the offer or sale would constitute misrepresentation, deceit or fraud on, the franchisee. *Id.* § 23-2-2.5-6.

89. *Id.* § 23-2-2.5-5; EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 89-90.

90. EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 90.

of a franchise with the Securities Commissioner in the Office of the Attorney General.<sup>91</sup> The Commissioner will then issue an order exempting or not exempting the proposed offer or sale, together with any findings of fact and conclusions. If an exemption is granted, the franchisor must then timely file the following: (1) a signed and verified Form F-1 Notice of Exemption; (2) a Consent to Service of Process naming the Securities Commissioner as its agent for service of process; (3) a statement agreeing to provide any additional information that the state may reasonably require; and (4) a copy of its current franchise disclosure document.<sup>92</sup>

#### E. *Michigan*

Michigan's discretionary exemption is separated into several exemptions. But, unlike most other states, Michigan's Franchise Investment Law identifies very specific sections that a franchisor may be exempt from in the discretion of the state Department of Attorney General. The scope of Michigan's discretionary exemption is therefore limited.

The Franchise Investment Law requires a franchisor to file audited financial statements in its registration application, but the Department of Attorney General may—in its discretion—waive this requirement subject to certain conditions where the financial statement is not necessary for the protection of the public, or where the Department of Attorney General is satisfied that the franchisor can financially perform its commitments to franchisees.<sup>93</sup> Likewise, if a transaction is already exempt from registration under an exemption based on the franchisor's net worth, the franchisee's initial investment, or a sale of a franchise to an existing franchisee, the Department of Attorney General may waive the requirement of certified and audited financial statements if disclosure is not necessary in the public interest or for the protection of potential franchisees.<sup>94</sup> Finally, the Franchise Investment Law requires that a franchise agent work exclusively for one franchisor with respect to an offer or sale of a franchise “unless the Department [of Attorney General] specifically authorizes by order the multiple employment on terms and conditions as are appropriate to the public interest.”<sup>95</sup>

#### F. *Minnesota*

Minnesota has a similar Purpose Condition, Public Interest Condition, and Protection Condition as many of the registration states.<sup>96</sup> However, the Minnesota Department of Commerce has provided many hints through

91. MD. COMAR. 02.02.08.10(G)(2). This request for an order must include a description of the proposed transaction, a description of the reasons why an order of exemption is appropriate under the state's conditions, and a statement confirming that the requesting franchisor will furnish any additional information that the Commissioner may request. *Id.*

92. *Id.* § 02.02.08.10(G)(5).

93. MICH. ADMIN. CODE r. 445.503.

94. *Id.* r. 445.504.

95. *Id.* r. 445.601.

96. MINN. STAT. § 80C.03(g).

previous orders that show different factors it considers. In determining the merits of a request for a discretionary exemption, the Commissioner has in the past considered (1) the sophistication of the parties; (2) the prior experience of the prospective franchisee with the franchise system; (3) whether the officer of the franchisee is an insider of the franchisor; (4) whether the franchisee is the franchisor's "wholly-owned subsidiary;" (5) whether the franchise offer is for the renewal of an existing franchise relationship on terms substantially the same as those governing the existing relationship; (6) whether the franchise agreement is simply formalizing previous informal arrangements; and (7) financial considerations involving financial performance representations.<sup>97</sup>

The Commissioner will render an interpretative opinion granting or denying an exemption request from the registration requirements.<sup>98</sup> Note that while the Minnesota Franchise Act does not require disclosure when an offer or sale is not registered per an exemption, the Commissioner may require disclosure in accordance with a different state's laws.<sup>99</sup> There are no published guidelines for requesting an exemption in an interpretative opinion, other than that the request "clearly set forth the basis upon which nonapplicability of the act is contended" and the Commissioner receives all pertinent documents.<sup>100</sup> Regardless, a franchisor will likely be most successful seeking an exemption if the proposed franchisee submits a supporting statement describing why the franchisee does not need the traditional protections under the law.<sup>101</sup> This statement is likely strengthened if the proposed franchisee has counsel or at least signs an acknowledgement or letter as to its experience or sophistication.<sup>102</sup>

### G. New York

In New York, the discretionary exemption may apply to both registration and disclosure requirements.<sup>103</sup> A franchisor may request a discretionary exemption by writing a letter to the New York Department of Law, describing the facts and basis for the request.<sup>104</sup> If the exemption is granted, there is no annual renewal requirement. However, the New York Department of Law may use its discretion to deny or revoke an exemption "with respect to a specific franchisor or transaction, or withdraw or further condition any exemption."<sup>105</sup>

97. EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 128.

98. MINN. STAT. § 80C.18 subd. 2; MINN. R. 2860.0300. Exemptions only apply to the transaction that is subject to the order. *See also* EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 128.

99. EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 128.

100. MINN. R. 2860.0300.

101. EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 129.

102. *Id.* at 129.

103. *Id.* at 158.

104. *Id.* at 159.

105. N.Y. GEN. BUS. LAW § 684(4).

#### H. North Dakota

A franchisor seeking a discretionary exemption in North Dakota must make a formal request by letter to the Securities Commissioner and include all reasons for the exemption. Some attorneys will also submit a \$150 fee for a “No Action” letter.<sup>106</sup> However, like Indiana, because of the relative ease to register, it may be more efficient to complete the registration process assuming the franchisor has a current franchise disclosure document.<sup>107</sup>

#### I. Virginia

Unlike the other discretionary exemptions, Virginia law grants the State Corporation Commission discretion to exempt the offer or sale of a franchise from registration by rule or order, but without satisfying any conditions as to the purpose of the Virginia Retail Franchising Act, public interest, or the protection of prospective franchisees.<sup>108</sup> Although the Public Interest Condition, Purpose Condition, and Protection Condition are vague,<sup>109</sup> the Virginia Retail Franchising Act leaves the most discretion to the state regulatory agency as compared to all other states with a similar exemption. Although the State Corporation Commission has promulgated additional exemptions by rule,<sup>110</sup> it has unsurprisingly not qualified its own power under the discretionary exemption.

#### J. Wisconsin

An application for a discretionary exemption under Wisconsin law should contain a letter explaining the basis for the exemption request as well as payment of a \$200 filing fee.<sup>111</sup> The Wisconsin Division of Securities may request additional information from a franchisor within ten days after a franchisor files an application for a discretionary exemption if necessary to determine whether to grant the exemption. If the Division of Securities requests this additional information, the effective date of the exemption is delayed by ten days.<sup>112</sup>

106. EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 174–75.

107. *Id.* at 174.

108. Compare VA. CODE § 13.1-560, with, e.g., S.D. CODIFIED LAWS § 37-5B-15; R.I. GEN. LAWS § 19-28.1-6(10); MD. BUS. REG. CODE § 14-214(b)(3).

109. These qualifiers may be practically vague, resulting in inconsistent application of the discretionary exemption on a case-by-case basis, but are not unconstitutionally vague. *E.g.*, *Carter*, *supra* note 41, 454 N.E.2d at 190 (the delegation of authority to state regulatory agencies to grant exemptions in the “public interest” is constitutional as “public interest” provides sufficient intelligible standards for a proper legislative delegation provided that this criterion is construed within the purposes of the state franchise law).

110. 21 VA. ADMIN. CODE § 5-110-75.

111. WIS. ADMIN. CODE DFI § 35.01(1)(a).

112. WIS. STAT. § 553.24(6).

#### IV. Exemption-Based Franchising

The discretionary exemption is typically used as a fallback if no other exemption applies. In limited situations, the discretionary exemption can be the primary exemption used. In either case, there are no guarantees for a franchisor that a transaction or the franchise system will be discretionarily exempted.

Although various exemptions from registration or disclosure requirements exist, it is often difficult for a franchisor (especially a nationwide franchisor) to structure its entire franchise sales program around exemptions.<sup>113</sup> Each registration state and the Federal Trade Commission rules have different exemptions, and even the same exemption often has different qualifications and processes for compliance. Even worse, some exemptions exempt a franchisor from the registration requirements only of the applicable law and not its disclosure obligations. Although exemption-based franchising can be a bumpy endeavor, the discretionary exemption may be a viable solution on a case-by-case basis as discussed below.

##### A. Process for Requesting Discretionary Exemptions

###### 1. General Form and Process

The discretionary exemption by order is not self-executing in any state, requiring a written request by a franchisor for an order exempting the franchisor's transaction. To be clear, the discretionary exemption cannot be used retroactively to defend against a franchisor's failure to register; in all states, a franchisor must actually seek and obtain an order granting the exemption before it offers or sells a franchise.<sup>114</sup> Illinois goes a step further requiring the franchisor to obtain a consent letter from the prospective franchisee after being granted a discretionary exemption but before it completes a sale of a franchise.<sup>115</sup> And Maryland's Securities Commissioner must first review and approve the request for a discretionary exemption, and, if granted, the franchisor must then file a Form F-1 Notice of Exemption at least ten days prior to a proposed offer or sale of a franchise.<sup>116</sup>

The state requirements to apply for a discretionary exemption vary widely. Most states have not specified any procedures to apply for the exemption. In these states, the best practice is to submit the necessary information in a letter addressed to the appropriate state regulatory agency. Regardless, any request for an order exempting a transaction must specify what registration or disclosure requirement(s) the franchisor wishes to be exempted from and persuasively explain why the transaction should be exempt based on the state

113. *E.g.*, Karen B. Satterlee & Leslie D. Curran, *Exemption-Based Franchising: Are You Playing in a Minefield?*, 28 FRANCHISE L.J. 191, 191-92 (2009) (discussing the advantages and disadvantages of exemption-based franchising).

114. *See, e.g.*, *In re Crd Enter. Inc. d/b/a Jan-Pro Cleaning Sys. of So. New England*, D.B.R. No. 10-S-0112 (R.I. Dep't of Bus. Reg. June 7, 2011).

115. *See supra* note 84 and accompanying text.

116. MD. COMAR 02.02.08.10(G)(5)(a).

conditions for granting a discretionary exemption. Further, the request must detail the facts surrounding the proposed offer or sale in light of the conditions. For example, if a franchisor seeks to claim a discretionary exemption based on the sophistication of a prospective franchisee or the prospective franchisee's prior experience with the franchise system, the request should provide sufficient detail showing the prospective franchisee's history, net worth, and experience. Even more helpful is obtaining a signed acknowledgment or letter from the prospective franchisee in which the prospective franchisee agrees that it does not need a registered franchise disclosure document. Depending on the circumstances, the request should highlight unique reasons why the state regulatory agency should exempt registration or disclosure of the transaction, such as listing other states that have exempted registration or disclosure of the transaction under the discretionary exemption or another exemption. Some states require additional information in the request for a discretionary exemption by order, such as representations that the franchisor will furnish any other information requested by the state regulatory agency. The burden of proving an exemption is on the person requesting the exemption (usually a franchisor).<sup>117</sup>

## 2. Maintaining Exempt Status

If a franchisor is granted a discretionary exemption from registration or disclosure requirements, the franchisor may still have ongoing duties to keep a franchisee informed of any material changes to the franchise relationship. A franchisor may be required to update a state regulatory agency regarding any changes to its franchise relationship; for example, to maintain its exempt status in Wisconsin, a franchisor must notify the state's Division of Securities of any "material event or material change" regarding the franchise relationship within thirty days of the occurrence of such event or change.<sup>118</sup> State regulatory agencies have equally broad power to revoke any granted exemption, often if in the public interest or to protect prospective franchisees.<sup>119</sup>

Either by law or by the terms of the state regulatory agency's order itself, a discretionary exemption will usually be limited to the transaction that is the subject of the order, and may not be relied upon in conducting other transactions unless a new discretionary exemption is obtained.<sup>120</sup> It is unclear in most states for how long a granted discretionary exemption is valid. In others, such as Illinois and Maryland, a discretionary exemption is valid for one year.<sup>121</sup> Typically, if a discretionary exemption is granted, the state regulatory agency will specify in its order the exempt transaction(s).

117. *E.g.*, CAL. CORP. CODE § 31153; N.D. CENT. CODE § 51-19-16(4); R.I. GEN. LAWS § 19-28.1-24.

118. WIS. ADMIN. CODE D.F.I. § 32.03.

119. *See supra* note 3.

120. *E.g.*, MINN. R. 2860.0300.

121. EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 75, 110.

### B. Suitable Franchise Transactions for the Discretionary Exemption

Certain transactions may be more likely to be discretionarily exempted by a state regulatory agency, often because the conditions stated in Part II.A.1 above are not present in the applicable transaction. But ultimately, state regulatory agencies have been inconsistent in granting discretionary exemptions by order because of their subjective conditions.<sup>122</sup> For instance, the state regulatory agencies in some states, including Indiana, Minnesota, North Dakota, and South Dakota, have by order exempted Internet offers of franchises and other franchise advertising (but not the actual sale) under their discretionary authority.<sup>123</sup>

The Minnesota Department of Commerce has previously granted discretionary exemptions by order in a variety of situations, including where the franchisee was an experienced business person, where an officer of the franchisee was an insider of the franchisor, certain renewals of existing franchises (even on substantially different terms), and to permit the disclosure of financial information to a franchisee when the franchisor's franchise disclosure document did not include an Item 19 financial performance representation.<sup>124</sup> In the authors' experience, the New York Department of Law has previously exempted a large franchisor on the basis of its unaudited financial statements based on the franchisor's history, franchise system size, and net worth that was a hundred times more than that required for claiming the state's large franchisor exemption based on audited financial statements.

The discretionary exemption should be used where the franchisor is unable to qualify for a specified exemption under the state's law or the applicable state law does not contain an applicable exemption. If a registration state lacks a typical exemption that many other registration states have, and which a franchisor has relied on in other states, the state regulatory agency in the state under consideration will more likely—but not certainly—grant a discretionary exemption based on the other exemptions (e.g., to fill in the gap). For example, Hawaii and Minnesota do not have an exemption from registration or disclosure of offers or sales of franchises by seasoned or experienced franchisors, whereas other registration states have such an exemption for large franchisors.<sup>125</sup> Similarly, a franchisor may qualify as a large franchisor in one state,

122. *E.g.*, Letter from David Byers, Director, Corporate Counsel, Starbucks Corp., to Dale Cantone, Chair, Office of the Attorney General, Division of Securities (July 29, 2011) (in commenting to NASAA's proposed uniform discretionary exemption, *supra* note 20, "In [Starbucks'] experience, different franchise examiners applying this [public interest or protection of prospective franchisees] standard have come to polar opposite conclusions, even when the underlying facts are essentially identical.")

123. Bradley W. Skolnik, Sec. Comm'r, Ind. Sec. Comm'r, Dec. 24, 1997, BUS. FRANCHISE GUIDE (CCH) ¶ 5140.011; James C. Bernstein, Comm'r of Commerce, Minn. Dep't of State, Dec. 4, 2002, BUS. FRANCHISE GUIDE (CCH) ¶ 5230.81; Debra M. Bollinger, S.D. Div. of Sec., Oct. 16, 2000, BUS. FRANCHISE GUIDE (CCH) ¶ 5410.20; Syver Vinje, N.D. Sec. Comm'r, Nov. 29, 2000, BUS. FRANCHISE GUIDE (CCH) ¶ 5340.02. Other registration states also exempt Internet offers for sale and online franchise advertising under the discretionary exemption by rule (the result is the same).

124. EXEMPTIONS AND EXCLUSIONS, *supra* note 4, at 127–29.

125. Compare, *e.g.*, HAW. REV. STAT. § 482E-4 and MINN. STAT. § 80C.03, with *e.g.*, CAL. CORP. CODE § 31109, MD. COMAR 02.02.08.10(D), and N.D. CENT. CODE § 51-19-04(1).

but may not be sufficiently large or experienced to qualify for a similar exemption in a different state. A request for an order exempting the registration or disclosure of the transaction in this case should make reference to the fact that the transaction is exempt from registration or disclosure in the other state(s), and the grounds thereof, and that the transaction is not within the purposes of the subject state's franchise law and that registration or disclosure is not necessary in the public interest or for the protection of prospective franchisees, as evidenced by the other state's exemptions and the fact that the franchisor is experienced. Another state's ruling that a similar transaction is exempt strongly supports a finding that the transaction at issue should be exempted under a discretionary exemption in another state because, at least theoretically, the purposes of all franchise laws, the public interest, and the interests of prospective franchisees are the same in all states. Franchisees, as a whole, are no more sophisticated in one state than in another state. The discretionary exemption can therefore be a powerful tool to obtain an exemption from registration or disclosure not otherwise available in a particular state. The use of the discretionary exemption in this fashion also aids franchisors in rolling out a nationwide franchise system via exemptions from registration or disclosure. Even if a franchisor cannot obtain a discretionary exemption in all the "gap" states, it can at least save some costs and time from having to register and/or disclose in the exempted state(s).

The discretionary exemption can be useful in a few other situations. For example, a state regulatory agency is probably more likely to grant a discretionary exemption involving a sale of only one franchise in the state as it is arguable that registration and disclosure is not necessary to protect the public interest in a single sale. Indeed, Illinois's discretionary exemption could be used to exempt the offer or sale of one or two franchises in the state in the ensuing year, as such a limited offer is statutorily within the public interest.<sup>126</sup> If a discretionary exemption is granted based on the size of the franchisor, such as the franchisor's net worth, the state regulatory agency will typically permit unlimited sales of franchises in that state by the franchisor for the duration of the exemption, whereas in other circumstances the discretionary exemption is granted for a specific transaction only.<sup>127</sup>

A franchisor also has a good chance of obtaining a discretionary exemption in those transactions where a franchisee is sophisticated or is an existing franchisee, or where a franchise requires a low franchise fee and startup costs, or where the transaction is otherwise objectively low risk. But the discretionary exemption can be used even if the franchise fee and startup costs are very high. For example, a discretionary exemption may be appropriate in certain industries by virtue of the type of franchisee involved and the franchisee's initial investment. The hospitality industry and larger restaurant chains typically support only an experienced franchisee with a strong net worth and abundant liquidity. The startup costs and risks are high in these franchises, so

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126. See *supra* Part III.B.

127. *E.g.*, MD. BUS. REG. CODE § 14-214(b)(3); MD. COMAR 02.02.08.10(G).

the franchisee is usually sophisticated and has sufficient bargaining power; the franchisee therefore does not need the protection of state franchise laws.<sup>128</sup>

A franchisor may be more inclined to seek a discretionary exemption in states with specific processes for requesting an order, such as in Illinois and Maryland. But the absence of specific details on how to request a discretionary exemption by order in a particular state should not, by itself, deter a franchisor from requesting an order. As noted earlier, in most states, the form for a request for discretionary exemption by order can be as simple as a letter. If counsel is presented with a transaction that, in his or her judgment, has a reasonable chance of being beyond the purview of a state's franchise law or that is similar to one of the earlier example transactions, counsel should consider the discretionary exemption option. Often times, in a quick phone call, the appropriate state regulatory agency may provide informal guidance on whether it may issue an exemption. Counsel can then consider the likelihood of obtaining a discretionary exemption in comparison to the time and expenses it may take to prepare a disclosure document and register and make an informed decision on how to proceed. If a state regulatory agency denies a request for a discretionary exemption by order, a franchisor could then consider registration and disclosure in the particular state. If time is of the essence, counsel can employ a two pronged approach, by beginning the registration and disclosure process while continuing to pursue the discretionary exemption by order.

## V. Conclusion

Thirteen of the registration states provide for an exemption from registration, disclosure, or both by administrative order or rule, so long as the proposed offer for sale or sale of the franchise is not within the purposes of the state's franchise law and the registration or disclosure (as applicable) of the transaction is not necessary in the public interest or needed for the protection of prospective franchisees. However, obtaining this exemption can be tricky and unpredictable based upon the different state requirements related to the grant of a discretionary exemption and the lack of guidance in other states. Nevertheless, for franchisors who are unable to qualify for another identified exemption under applicable law, a discretionary exemption may be the only viable alternative.

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128. See *Cont'l Basketball Ass'n v. Ellenstein Enter., Inc.*, 669 N.E.2d 134, 141 (Ind. 1996) ("While the integrity of offers and sales of franchises in Indiana is certainly an important public policy, we see little likelihood that refusal to enforce a professional sports franchise agreement between highly sophisticated parties will further that policy. In short, a sports franchise agreement among highly sophisticated parties is so far from the typical franchise transaction which the [Indiana] Franchise Acts were designed to regulate that we can adhere to our strong presumption in favor of the enforceability of contracts without undermining the purposes of the Acts.").

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