

# FRANCHISE REGULATION

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## HISTORY

Franchising in its current form evolved in the United States predominantly in the 1950s and 1960s. During that period, franchising experienced explosive growth in terms of the number of companies using franchising and the number of different industry sectors in which franchising was used, and in the variety of ways that franchising was used to pursue a wide array of business objectives. Unfortunately, much of this growth occurred as a result of franchisors promoting their franchise offerings with very little regard to the investment information needs of their prospective franchisees. Few franchisors provided meaningful pre-commitment investment information, and many sold franchises on the basis of claims and representations that lacked meaningful substantiation. In addition, several noteworthy outright frauds were perpetrated on naïve or unsuspecting investors.

In the late 1960s, several states attempted to address these problems by using state securities regulation laws and unfair trade practices laws to regulate abuses in the offer and sale of franchises. These efforts were largely unsuccessful.

In 1970, California's legislature became the first in the nation to adopt a law aimed directly at the offer and sale of franchises. The California Franchise Investment Law became effective January 1, 1971. It was modeled after the California Securities Law and required that franchise offerings be registered with the Department of Corporations before any offer could be made to sell

a franchise in California. It also dictated that a lengthy pre-commitment disclosure document be delivered to each prospective franchisee at a prescribed time before the franchisee could make any payment or sign any binding agreement related to the franchise.

Over the next five years, 14 other states enacted similar laws. The Minnesota Franchise Act became effective August 1, 1973. In 1979, the Federal Trade Commission joined the 15 states that then regulated the offer and sale of franchises by enacting a Trade Regulation Rule on Franchising and Business Opportunities Ventures. In 2007, the Federal Trade Commission updated the FTC Rule. The amended Rule reduced inconsistencies between federal and state franchise disclosure requirements, and moved business opportunities into a separate Rule.

The franchise laws were generally effective in achieving their intended results to provide prospective investors in franchises a substantial body of information to allow the investor to compare offerings, and to make an informed judgment as to the suitability and merits of the franchise opportunity presented. The laws are also intended to provide franchise investors with legal remedies against those franchisors that fail to make the prescribed disclosures, misstate important information in the Franchise Disclosure Document, or leave out important information necessary to make what was disclosed fully accurate. The laws were never intended to, and do not, protect investors from making bad investment judgments, or to protect investors against franchise programs run by companies that are incompetent, arrogant or simply unsuccessful.

Another common misconception about franchise laws is that they prevent crooks from using franchise opportunities to defraud people. The laws do not and cannot prevent such activity. The most they can offer is the slim prospect of an after-the-fact remedy if the crook can be identified and tracked down. Dishonest people and companies tend not to comply with registration and presale disclosure laws in the first place.

## REGISTRATION AND DISCLOSURE

As in most states that regulate franchise sales, the heart and soul of Minnesota franchise sales regulation is the requirement that a franchise offering be registered with a state administrative official before it may be offered to anyone, and that the franchisor provide to each prospective investor a comprehensive set of disclosure information in the form of a prospectus on the franchise offering. This is known as the Franchise Disclosure Document (or FDD).

Both the FTC Rule and Minnesota law require that the Franchise Disclosure Document provide information in 23 separate categories. Franchisors are required to make known various facts about the franchise including the name of the franchise, business address of the franchisor and any parent companies, the nature of the franchise offering, the competitive market circumstances in which the franchised business will be operated, background information on the franchisor and its officers and directors, litigation and bankruptcy history for the franchisor and its principals, a summary of fee and initial investment information, restrictions on the franchisee's purchasing discretion, financing information, trademark information, whether the franchisor does or does not provide any kind of earnings or financial performance ("track record") information, and statistical information about the franchise system. The Franchise Disclosure Document also contains the audited financial statements of the franchisor, a specimen of the franchise agreement and related agreements, and a list of existing franchisees.

Franchise Disclosure Documents can often run to 100 pages or more. The information they contain is usually quite detailed and technical. The quality and depth of information provided can vary significantly from one offering to another. In reviewing and interpreting the information contained in the Franchise Disclosure Document, a prospective franchisee should always obtain independent professional advice from either an experienced franchise lawyer or perhaps a certified public accountant with significant franchise experience.

In multi-state transactions – such as a situation where a prospective franchisee may be a resident of one state but considering purchasing a franchise to be located in another state – more than one state’s FDD may have to be delivered to the prospective franchisee to satisfy the requirements of each state’s laws.

Before offering a franchise in any of the registration states, the franchisor is required to register that offering with the state franchise law administrator. In Minnesota, the administrator is the Department of Commerce. Registration is accomplished by filing with the administrator a proposed form of the FDD, together with certain additional forms and other information prescribed by law and by state regulations.

The Department reviews the FDD and certain related information also required to be filed. It often requires additional or restated information in the proposed FDD. The Department will issue an order of registration when it is satisfied that the FDD addresses the required areas of disclosure. The order of registration then entitles the franchisor to make offerings to prospective investors in Minnesota for a limited period of time.

The Department of Commerce does *not* assess the merits of the offering or determine the accuracy or completeness of information in the FDD. At best, staff employees of the Department check that each category of information called for by the FDD requirements has at least been addressed in the FDD. Prospective franchisees should *not* rely upon the fact of registration or the fact that an FDD has been reviewed by the Department as a substitute for making their own comprehensive investigation of the proposed franchise.

Registration orders are valid for up to one year. A franchisor has an obligation to amend the FDD promptly upon the occurrence of any material change in the information contained in the FDD, but franchisors are generally under no obligation to make disclosure retroactively to persons who have already purchased a franchise.

If a prospective franchisee has received an earlier FDD and is still considering the investment when a material change occurs, the franchisor must make an updated disclosure to the prospective franchisee before completing the sale.

The franchisor is required to file an annual report with the Minnesota Department of Commerce which updates the information in the FDD. It must do so no later than 120 days after the franchisor's next fiscal year end or by the first anniversary of the registration order, whichever occurs first. In most cases, new audited financial statements are required in connection with the annual report.

The other registration states follow essentially the same regulatory pattern, with a couple of exceptions. Michigan and Wisconsin require a notice filing with a state agency but do not review FDDs. Oregon, like the FTC Rule, mandates disclosure but does not require filing or registration. Hawaii conducts a cursory review of FDDs but not a full registration scrutiny. A few states (including Florida, Kentucky, Nebraska, Texas and Utah) require an administrative notice filing with a state agency to claim an exemption (for franchise offerings) under the state business opportunities law, but do not otherwise register or review FDDs.

In most of the other registration states, the review process is essentially identical to that in Minnesota. Variations in specific items of state law may result in slightly different versions of FDDs for use in the various states. Consequently, in some multi-state transactions, franchisors may be required by the various laws to deliver more than one state's FDD to the prospective franchisee whether or not those offering circulars differ slightly from state to state. The state statutes have never adequately dealt with that problem, and any inconsistencies within the FDDs are usually sorted out on a case by case basis. Many FDDs address multi-state inconsistencies or unique disclosure requirements of single states by adding one or more "state addendums" to the FDD.

One of the more important features of pre-sale disclosure that prospective franchisees should be aware of is the minimum time in which the prospective franchisee is entitled to obtain disclosure before being asked to make any commitment. Under the FTC Rule, the franchisor is required to deliver the FDD to the prospective franchisee at least 14 days before the prospective franchisee makes any payment to the franchisor, or 14 days before the prospective franchisee signs any binding agreement relating to the franchise, whichever occurs first or, if earlier, at the “reasonable request” of the prospective franchisee.

Franchise Disclosure Documents may be delivered in paper format, on a CD, or electronically by email or download from a web site, provided the franchisee is informed of the right to request and receive a paper (or “hard copy”) version.

The effect of the pre-commitment disclosure obligation is to provide the FDD to the prospective franchisee long before the prospective investor may be required to make any financial or binding contractual commitment to acquire the franchise. This is intended as a cooling off period to enable the prospect to consider carefully all of the FDD information, and to enlist the assistance of a lawyer, CPA or other trusted business advisor to assist in interpreting the information provided.

The prospective franchisee will be asked to sign a “Receipt,” which is the last page of the FDD. This document merely indicates that the prospective franchisee did in fact receive the FDD on the date indicated. It does not otherwise obligate the prospective franchisee in any way, but investors should be careful to read the Receipt before signing it to be certain that it does not contain factual inaccuracies.

The law also requires that the prospective franchisee be furnished with a complete copy of the FDD (including a duplicate of the Receipt), without charge.

The philosophy of the franchise registration and disclosure requirement is to provide prospective franchisees with pre-commitment information so that relatively informed investment decisions can be made. The purpose is not to prevent prospective franchisees from making imprudent or unsuitable investment commitments.

The information in the FDD is intended to give the prospective franchisee a clear sense of what he or she is being asked to invest in. It provides a basis upon which the prospective investor can compare one franchise offering to another – sometimes even across industry lines – to weigh the cost and benefits of, for example, a doughnut shop franchise as compared to a dry cleaning franchise. It provides a starting point for the prospective franchisee to conduct his or her own investigation into the suitability of the investment, the track record of the franchisor, and prospects for success.

The information in an FDD by itself is never enough information for a prospective franchisee. While it is true in some senses that a prospective investor in an independent small business can never have too much information about the proposed investment, it is worth noting that the FDD should be thought of only as a starting point in conducting a pre-commitment investigation into the proposed business arrangement. For example, the FDD rarely contains sufficient information about the competitive environment and long-term trends in the business sector in which the franchise will be operated. It is up to each individual investor to ascertain whether the business prospect being investigated might be vulnerable to rapid technological obsolescence, unusually intense competitive pressure, trends towards consolidation at the level of either franchisees or the franchisor, or might itself have regulatory requirements with which the prospective franchisee is not equipped to cope. Many FDDs carry little if any of this information.

FDDs sometimes do not disclose the identity of the *ultimate* controlling parties behind the franchisor.

FDDs also do not provide sufficient information for a franchisee to compile a complete operating budget for the business, even though initial, pre-opening capital outlay requirements are spelled out. The assistance of a skilled accountant should be sought to develop a one-year and five-year operating plan.

The most glaring omission from most FDDs is disclosure of the financial performance history of the franchisor's other franchisees. For odd historical reasons, this crucial bit of information is still not a required disclosure.

The FDDs for many franchise programs leave it entirely to the prospective franchisee to locate his or her own sources of financing, find and acquire a site, and perform other similar critical start-up requirements.

The composition and quality of franchise offerings varies significantly from one industry sector to another, and even within sectors. Prospective franchisees owe it to themselves to shop aggressively before making a commitment to any particular industry sector or a specific franchise organization.

Other good sources of information to help find or evaluate a franchise offering are available to prospective franchisees. These sources include the following:

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| A given franchisor's FDD      | State agencies (in Minnesota, the Department of Commerce)          |
| A competitor franchisor's FDD | Better Business Bureau<br>American Franchise Association (Chicago) |

Federal Trade  
Commission  
(Washington D.C.)

American Association of  
Franchisees and Dealers  
(San Diego)

Franchisees of a given  
franchisor (listed in  
the FDD)

International Franchise Association  
(Washington, D.C.)

Professional advisors,  
such as an attorney  
or CPA

Public library

### **Cooling Off Provisions**

Because the law requires that the FDD be delivered no later than 14 days before the prospective franchisee signs a contract or makes any payment with respect to the franchise being offered, a franchisor cannot require its prospective franchisees to sign contracts, make deposits, pay earnest money, or make any other payment or commitment with respect to the franchise until the prescribed cooling off period of 14 days has elapsed. Once that time has passed and the franchisee has committed to acquire a particular franchise, the franchisor may then, if the practice is properly disclosed in the FDD, require the payment of deposits or prepayments of all or part of the initial franchise or other fees in conjunction with the execution of the franchise agreement, or perhaps a preliminary agreement governing the parties' working relationship until the franchise agreement itself is issued. Some franchisors will then ask the prospective franchisee to sign a confidentiality agreement. These practices vary significantly from one franchise offering to another, and the requirement that such a deposit or prepayment be made or preliminary contract be signed is not necessarily an indication that the franchise offering involves a high level of risk.

## **Financial Conditions to Registration**

In many cases, the Department of Commerce will condition the registration of franchise offerings by small, start-up, or otherwise undercapitalized franchisors upon the franchisor establishing an escrow account in a bank in Minnesota. Under such an “impound order,” the franchisor is required to deposit all initial franchise fees into the prescribed escrow account under a three-party agreement between the franchisor, the bank and the Minnesota Department of Commerce. The initial fees are held in the escrow account until the particular franchisee has opened the franchise for business. The franchisor may then petition the Department of Commerce for permission to obtain a release of that franchisee’s initial franchise fee from the escrow account. The Department contacts the prospective franchisee to ascertain whether all of the promised pre-opening services have been provided. If they have, the franchise fee will be released to the franchisor. But if the franchisee is dissatisfied with the level of support service, the Department may intervene to investigate, or simply to freeze the escrow account until the franchisee consents to its release or until the franchisor can satisfy the Department that the franchisee is being unreasonable in refusing to allow the release of the funds.

The existence of an impound order requiring the creation of such an escrow account is not always properly disclosed in the FDD. Franchisees dealing with small, start-up or thinly capitalized franchisors should ask the Department of Commerce whether such an order is in place.

Instead of escrowing initial franchise fees, some franchisors facing an impound order may choose instead to post a bond with the State of Minnesota assuring compliance with the terms of the offering. These arrangements are not always properly disclosed in FDDs, so a prospective franchisee should ask the Department of Commerce whether such a requirement has been established in a particular offering.

A third alternative, which the Department of Commerce sometimes accepts, is for the franchisor to agree in writing to defer the franchisee's payment of the initial franchise fee until the franchised unit opens for business.

Impound orders or bonding obligations are meant to assure satisfactory completion only of pre-opening support services. They may not be relied upon for financial assurance in respect to ongoing operating support promised by a particular franchisor.

### **Other Contracts**

Each contract that a franchisee may be required to execute with the franchisor or the affiliates of the franchisor must be in the FDD. This allows cautious and comprehensive review of those legally binding contractual obligations in advance of making a commitment. If a franchisee later finds that the franchisor is requiring the franchisee to sign some other agreement beyond those set forth in the FDD, the franchisor may be acting in violation of the law.

### **Material Changes to the Form Agreement**

If the franchisor unilaterally makes changes to the Franchise Agreement or other contracts that are attached to the Disclosure Document which the franchisee will be required to sign, a final copy of the franchise agreement and/or other contracts must be disclosed to the prospective franchisee at least seven calendar days before execution. This requirement does not apply to changes initiated and negotiated by the franchisee, or to clerical entry of information such as names and addresses into blanks in a form contract.

### **Negotiating a Franchise**

A curious nuance of the franchise registration and disclosure process is the question of whether a franchise may be negotiated before it is signed. Unfortunately, state administrators in some

states (other than Minnesota) have taken the position that once registered, a franchise offering is essentially locked in to precisely that form of agreement and that it is illegal for the franchisor to negotiate the terms of the franchise with prospective franchisees before signing the agreement.

This interpretation is not supported by the law. Prospective franchisees should consider themselves perfectly entitled to request modification of a franchise offering to deal with the particular business circumstance or needs of that prospective franchisee. This is certainly the case in Minnesota. There is no assurance that a franchisor will agree to negotiate the terms of a franchise; indeed, many do not. In most states, franchisors are under no legal duty to bargain over the terms. But there is no legal reason why a prospective franchisee should not at least ask whether the franchisor is willing to make appropriate modifications either to fine tune a franchise to the particular market or other circumstances faced by a prospective franchisee, or to remove or mitigate objectionable or overreaching terms of the form contract.

Ordinarily, even if a franchisor might be willing to make concessions in some areas, prospective franchisees should not expect any franchisor to modify the basic terms of the franchise, including the initial fee, royalty rate, and other fundamental or structural components of the franchise offering.

Except in California and North Dakota, a franchisor is not required to disclose or register subsequent changes in an existing franchise.

### **Additional Franchises**

A person who is already a franchisee in most cases is also a *prospective* franchisee in respect to an additional franchise in the same system or even a renewal franchise offered to him or her, even if the franchisee has had a long-term franchise relationship with that franchisor already. As a prospective franchisee in respect

to the new or renewal franchise, the franchisee is entitled to the full benefit of the disclosures and cooling-off period required for any other franchise transaction.

### **Sales by Franchisees**

A franchisee selling its own franchise for its own account on an isolated basis (*i.e.*, neither as agent for the franchisor nor as part of a pattern of such sales) is exempt from the registration requirement. A buyer from that franchisee is *not* entitled to receive an FDD before or after closing on the sale. The buyer should request voluntary disclosure of a current FDD from the franchisor for background information even if the franchise agreement being transferred is on an older and different form of contract than the most current contract described in the current FDD. Only if the franchisor is closely involved in the transfer does it become a “seller” of the franchise, requiring it to make disclosure to the existing franchisee’s transferee. This can happen if the franchisor acts as a “broker” for the sale by advertising for the buyer, participates in the negotiation of the terms of the sale, or issues a new or replacement franchise agreement to the buyer.

### **FRANCHISE RELATIONSHIP REGULATION**

In addition to requiring registration and pre-sale disclosure for franchise offerings, Minnesota and some other states regulate to a limited extent the content of the franchise agreement and the conduct of the ongoing relationship between franchisor and franchisee. These regulations focus largely on the ending of the franchise relationship – whether by assignment, expiration or termination. Minnesota’s franchise relationship regulation is found in Sections 13 and 14 of the Minnesota Franchise Act and the regulations adopted thereunder. The advice of an expert franchise lawyer should be sought before trying to apply these regulations to particular facts and circumstances.

Like the registration and disclosure requirements, Minnesota's relationship regulations reflect market circumstances that existed in the 1960s and 1970s. As such, they are somewhat out of date. Much of what they cover is no longer a concern in most sectors of franchising, and they fail to cover many of the areas that more recently have become matters of concern to many franchisees. These include encroachment, abusive sourcing restrictions, or management of system advertising funds. For instance, the relationship regulations prohibit termination of a franchise without "good cause," substantial advance notice, and (in most cases) ample opportunity to cure a default. The need for this regulation is reduced given that arbitrary or abusive terminations of business format franchises are rare today, even in the large number of states that have no such laws on the books. But this prohibition still has considerable value to franchisees trying to resist what they perceive as an unjustified termination.

The franchise relationship laws and regulations do not assure franchisees of the competence, integrity, leadership, financial health, or survival of their franchisors. Thus, thorough "due diligence" in investigating a proposed franchise investment is always prudent. Nevertheless, the "unfair practices" sections of Minnesota's relationship regulations do provide an unusually strong statement of a minimum set of rules by which the game of franchising is to be played.

Roughly seventeen states have laws and regulations that govern the franchise relationship. A handful provide comprehensive codes of regulations like Minnesota's, while most provide only limited protection in one or two specific areas, such as by simply prohibiting termination of a franchise without "good cause."

The FTC Rule does not regulate franchise relationships beyond the presale disclosure mandate.

## **Other Franchise Classifications**

Another matter that is outside the scope of this book but warrants brief mention is that Minnesota and many other states have special franchise and other related statutes that apply to a wide variety of industry classifications. Under the Minnesota Franchise Act itself, special sets of regulations are in force with respect to motor vehicle fuel franchises, burglar alarm franchises, hardware franchises, distributorships for beer and alcoholic beverages, farm implements, heavy industrial equipment, and motor vehicles. Manufacturers' representatives are also protected by a law that assures timely payment of earned commissions.

