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**GO TO THE HEAD OF THE LINE: HOW TO GET  
REGISTERED, AMENDED, RENEWED OR EXEMPTED**

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\* The opinions expressed in this paper are not those of the Illinois Attorney General, the Virginia Division of Securities and Retail Franchising or the North American Securities Administration Association (“NASAA”).

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## **I. INTRODUCTION**

Franchise compliance is a multifaceted and variable experience in the U.S. In most states, a franchisor may not have to comply with any franchise disclosure law at all by virtue of an exemption under the FTC Franchise Rule (the "FTC Rule"). If not exempt, the franchisor must prepare a Franchise Disclosure Document ("FDD") but need not file it with any government agency.

In 14 states, however, the compliance burden increases. Four of those states - Indiana, Michigan, South Dakota and Wisconsin - add only a minimal filing and a fee. The other ten states - California, Hawaii, Illinois, Maryland, Minnesota, New York, North Dakota, Rhode Island, Virginia and Washington - up the ante. And several of those states put a franchisor through a virtual gauntlet before they will allow franchise offers in the state.

This paper is intended to give guidance to franchisors on various strategies, techniques and best practices relating to four major aspects of franchise compliance: initial registration; registration renewal; amendments and obtaining exemptions. The authors do not pretend to have all of the answers but are representative of the various constituencies involved in the franchise compliance processes described above. In addition, while the authors attempted to prepare an integrated paper, there are considerable variations in points-of-view expressed in this paper. However, all share the desire to streamline and rationalize the compliance process for the benefit of franchisors while taking into account the need to protect prospective investors.

## **II. ORIGINAL APPLICATIONS FOR REGISTRATION**

Applications for franchise registration differ widely among the registration states in what is required to be filed as well as the level of review the application is given. Four states, Indiana, Michigan, South Dakota and Wisconsin only require that the FDD be filed and it is effective upon receipt by the regulatory authority. The remainder of the registration states require the filing of various documents including the franchise disclosure document and a filing fee. In these states, the regulators have the authority to conduct whatever level of review they choose. Since the focus of this paper is to provide franchisor counsel the information it needs to expedite successful registration, this section will focus on the initial application process for franchisors, with an emphasis on expediting registration in the State of Illinois which is well known for conducting "thorough" reviews of the entire application. In addition, this Section also provides some of the "Hot Button" issues for regulators in all of the states.

Under the Illinois Franchise Disclosure Act (the "Illinois Franchise Act"), sales to Illinois residents or for franchises to be located in Illinois where the offer of the franchise is made or accepted in Illinois must be registered prior to the offer of the franchise. Prior to registration, the franchisor must limit its contact with prospective franchisees to taking their contact information. The Illinois Attorney General's Franchise Bureau (the "Bureau") is the state's regulatory authority. The Bureau maintains approximately 1200 registrations per year and received over 350 original applications for registration in 2010.

Once filed, the Bureau has 21 calendar days to review and act upon the application. If no action has been taken within the 21 day period, the application is automatically registered. However, it should not be assumed that because franchisor counsel has not received any response to the application within the 21 day period that it is registered. Counsel should contact the Bureau to determine the status to avoid the offer and sale of unregistered franchises which would put the franchisor in violation of the Act. Once reviewed, the application may be denied

by administrative order, registered subject to certain revisions or, if the application is in complete compliance, it will be registered with no additional revisions required.

All of the review states require the 2008 NASAA Guidelines (the "Guidelines") application documents be filed. Although these forms have been required with each franchise application filed since July 1, 2008, many franchisors are still filing the forms which were required under the UFOC Guidelines. The documents are fairly self-explanatory in the manner in which they are to be completed, but the NASAA Guidelines includes directions. These documents should not be included in the franchise disclosure document (the "FDD"). The Certification which is attached to and made part of the Uniform Franchise Registration Application form and the Uniform Consent to Service of Process must contain original signatures from an officer of the franchisor. The Auditor's Consent Letter must be manually signed and placed on the accountant's letterhead. If another entity will guarantee the franchisor's performance, submit an originally executed Guaranty of Performance and an originally executed Uniform Consent to Service of Process from the guarantor. The Guidelines require the filing of CD-ROM in Portable Document Format ("PDF"), but for original applications filed in Illinois, the CD-ROM should not be filed until the application is registered.

The first way to expedite the registration process in the State of Illinois is to include the correct financial statements in the FDD. Failure to do so will result in the denial of the application with no further review of the FDD (outside the financial statements). The FDD must include audited financial statements for the prior three fiscal years which have been prepared according to United States generally accepted accounting principles ("US GAAP"). However, franchisors who are filing their first application with the Bureau and who have never had audited statements may request the "Phase in of Audit" which allows them to file financial statements which have been compiled by an independent CPA in accordance with US GAAP. The franchisor should notify its CPA to count the opening inventory at the beginning of the franchisor's fiscal year which commences after registration has been granted because at the end of that year the balance sheet must be audited. The remainder of the statements for that fiscal year may be unaudited but must be independently prepared in accordance with US GAAP. Financial statements for the following fiscal year must be fully audited.

Franchisor counsel should next evaluate the franchisor's financial condition to determine whether or not the imposition of financial assurance requirements is likely to occur because of the franchisor's financial condition and, if so, provide for that requirement when the application is filed. Financial assurance requirements are automatically imposed if the franchisor's most recent balance sheet discloses a negative net worth or the auditor has issued a going concern opinion. If counsel is uncertain as to whether such requirement would be imposed by the Bureau, it is free to contact one of the Illinois Examiners prior to filing the application. Contacting state examiners directly to discuss financial assurance requirements is often the most informative and efficient way to determine whether an assurance such as a fee deferral, escrow, impound, bond or surety may be required. If the Bureau determines that financial assurances are required and no provision has been made for them in the application, then the application will be denied with no review of the FDD having been made.

Whether the application is denied for deficient financial statements or financial condition, the franchisor will have 90 days to cure the deficiency. Failure to do so in that time period will require the franchisor to file a new application, including the fee, should it choose to pursue registration in Illinois. If a response is made within the 90 day cure period, the examiner will have 21 days to review it. If the deficiency has been cured, the entire FDD will be reviewed. If that review indicates significant deficiencies, the Franchisor will be granted a new 90 day cure



period to file a compliant FDD. If the deficiency has not been cured, a letter will be sent and the Franchisor will only have the remainder of the initial 90 day cure period, if any, to do so. Either way, the application process will take significantly more time.

Assuming there is no problem with the franchisor's financial statements or its financial condition, the application documents and the FDD will be reviewed for compliance with the NASAA Guidelines, the Commentary on the Guidelines (the "Commentary"), the Act and certain provisions of the FTC Rule. The Illinois Examiners conduct an extensive and thorough review of each FDD filed with an original application. Therefore, the document should be written with the following overall rules in mind:

- First and foremost, disclose all information required by the Guidelines whether or not it applies to the franchisor applicant and/or the franchise being offered. If information is not applicable, a negative disclosure must be made. For example: if the franchisor does not have parent company, state that; if no officer of the franchisor owns an interest in a supplier, state that; etc.
- Disclose all information in the manner required by the Guidelines and the Commentary. The Commentary provides guidance on what needs to be disclosed and how to disclose certain information. The Commentary can be found on the Illinois Attorney General's website at [www.illinoisattorneygeneral.gov](http://www.illinoisattorneygeneral.gov) by clicking on "Protecting Consumers" and "Franchise Information." The FAQs on the FTC Rule should also be examined and followed.
- Do not use ambiguities in the FDD. For example, do not disclose in Item 6 that certain fees "will vary." If no set fee or cost can be given, disclose a range or formula for determining the amount. Do not state that the franchisor may grant an exclusive territory in Item 12 without providing the factors or criteria that it uses in making this decision.
- Make certain there are no inconsistencies in the disclosure within each Item, between two Items or between the Items and the agreement(s). We often see disclosure in Item 5 that states that the initial fee is not refundable, but in Item 11 it states that, if an acceptable site is not agreed upon or the franchisee fails to complete training to the satisfaction of the franchisor, the fee will be partially refunded. If in Item 5 it is disclosed that the franchisee must purchase certain goods or services from the franchisor or an affiliate prior to opening of the franchise business, make certain that in Item 8 it is not disclosed that the franchisee can purchase these goods or services from the franchisor, its affiliate, or an approved supplier.
- Do not disclose information which is not required to be disclosed. The FDD is not promotional material and, therefore, should not contain that type of information. Do not use introductory paragraphs unless the Guidelines requires them.
- Do not use bold, italics or upper case type unless so required by the Guidelines. This is often done in Item 19 to accentuate disclaimers and admonitions.

- Do not disclose any disclaimers or admonitions unless required by the Guidelines. Item 19 requires only one admonition, "that a new franchisee's individual financial results may differ from the result stated in the financial performance representation." Item 11 should not include site location and lease approval disclaimers.
- Amend any provisions which are inconsistent with state law or the FTC Rule. State modifications may be made in an addendum to the disclosure document and the agreements. Generally, these provisions relate to governing law, jurisdiction and venue and waivers. If an addendum is used to amend an agreement, it must contain a signature and date line for both parties and must be executed simultaneously with the agreement. Addendums to the disclosure Items can only be used to provide for state specific information which does not include a revision required by only one specific state. All information required by the Guidelines must be disclosed in the applicable Item. Integration clauses must be amended in the agreement(s).
- Use plain english. This is not limited to the avoidance of legal jargon. The FDD must be written in a manner that is easily understood by a person unfamiliar with the business. Do not use run on sentences or disclosure which is unclear and convoluted. Proofread and edit the FDD before filing.

### **Some Key FDD Review Issues**

- **Cover Pages.** Follow the mandatory format and make sure the amounts are identical to those used in Items 5 and 7. Include risk factors only if required under the FTC Rule or by state examiners.
- **Item 1.** A reader should be able to discern the franchisor's history and its current corporate family.
- **Item 3.** The disclosure should include 3 types of cases: (a) pending cases involving enumerated claims or those that are financially material; (b) concluded cases involving claims described in (a) above where the franchisor was held liable or entered into an adverse settlement; and (c) cases the franchisor filed against a franchisee in the prior fiscal year.
- **Item 5.** Initial fees include not just franchise fees, but also all other initial payments to the franchisor or any affiliates.
- **Item 6.** Include all ongoing payments to the franchisor, including contingent payments.
- **Item 7.** Make sure the range used is all-inclusive so it covers the highest possible investment for a typical franchise. Note that some items focus on opening amounts (such as inventory) while other amounts reflect a period beyond opening, often 3 months (such as rent or working capital).
- **Item 8.** This item is intended to cover all items that are subject to any sourcing restrictions. Also the amount of sales of source-restricted products by the franchisor or its affiliates must be provided as of the most recent fiscal year end.

The same is true of rebates paid to the franchisor by suppliers who sell to franchisees.

- **Item 10.** All direct and "indirect" financing must be disclosed and indirect financing includes situations where the franchisor receives payments from a lender or has an agreement with the lender to provide franchisee financing.
- **Item 11.** Some of the key issues in this information-packed item are: reporting allocations of expenditures from the advertising fund; accessibility of operating manuals; computer system costs; and details on the training programs.
- **Item 12.** Disclose any reservation of rights by the franchisor to engage in other forms of distribution.
- **Item 13.** If the marks are licensed to the franchisor, describe the term of and rights provided by the license.
- **Item 17.** Provisions should be summarized and not copied from the agreement. Note the special disclosure regarding any integration clause (that it cannot negate any representations in the FDD).
- **Item 19.** Franchisors have great flexibility in preparing a financial performance representation but the key concern is whether the data used is a representative sample. It is difficult to use anything other than historical data.
- **Item 20.** All of the numerical data should be reconciled and the summary data in Tables 3 and 4 should flow over to Table 1. Also, the lists of current and former franchisees should reconcile with the tables. And don't forget to address confidentiality agreements and franchisee associations.
- **Item 21.** If the financial statements reflect a negative net worth, a working capital deficiency or a history of losses, expect questions from examiners. Disclose any guaranties.
- Finally, make certain that the Receipt pages are placed at the end of the entire FDD and are separate and detachable from it.

These rules, of course, are not all inclusive and do not attempt to represent all potential disclosure problems. However, by following them, franchise counsel is less likely to have the document summarily rejected or to receive an incomplete review.

As stated above, if there are no deficiencies in the FDD, registration will be granted and a letter to that effect will be sent. Registration can also be granted when there are a few deficiencies on the condition that they be cured within 30 days and that the FDD is not given out until the revisions are made. The letter to the franchisor's counsel will have an attachment on which the deficiencies will be listed. Unfortunately, in most cases, the application is denied by administrative order because the FDD has too many deficiencies. In this case an Order of Denial is issued to which is attached the list of deficiencies and the franchisor is allotted 90 days to cure them. It is important to note that it is a 90 day cure period. That does not mean that the franchisor has 90 days to respond to the Order of Denial, but rather 90 days to fix all of the problems in it. It is important to contact the examiner assigned to the application with any

questions or disagreements regarding a deficiency. Do not express your disagreements and/or arguments in a cover letter because it may waste valuable time if the examiner determines that the argument is incorrect.

The best way to contact an examiner in Illinois is by e-mail. If the examiner believes it is an issue that warrants a conversation, he/she will telephone counsel or arrange for a convenient time to speak. Please do not attempt to contact the examiner only to determine the status of a filing. That information can be provided by the secretary who answers the call. Only contact the examiner if you have a specific question or disagreement and not just to argue with them about their review practices. No matter the level of review an application gets, the mere fact that only one state requires a certain revision, does not mean that the deficiency does not exist and an examiner will rarely accept this rationale in determining whether to waive a requirement.

It is in the best interest of not only prospective franchisees, but also the franchisor who offers the franchise, that the FDD be fully compliant with all state and federal requirements. Although a compliant FDD will not prevent all problems which can arise in the franchise relationship, it will help to lessen the risks of those problems resulting from poor or inadequate disclosure. State examiners do not enjoy issuing lengthy comments and appreciate franchise counsel that file compliant applications. This makes everyone's job easier and allows the franchisor to begin offering and selling franchises sooner rather than later.

### **III. RENEWAL OF STATE FRANCHISE REGISTRATION**

#### **a. Renewal Process**

According to the FTC Rule, a franchisor must update its FDD annually (at a minimum) to include current information about the franchise system. This must be done within 120 days of the close of the franchisor's fiscal year. Annual updates must include new audited financial statements, updated litigation disclosures, the most recent information about current and former franchisees and any other new material information about the franchisor, the system or the terms of the franchise offering.

It is important to note that many franchise registration/disclosure states have annual reporting requirements that are different from the annual update required by the FTC Rule. In most of these states, the franchise registration expires at the end of a fixed one-year registration period, usually tied to the initial registration date. A renewal application must be filed in a timely manner (usually 15-30 days prior to the anniversary date of the current registration) to avoid a lapse in registration.

Other states, rather than using an annual renewal date, require renewal and FDD updating within 90 – 120 days of the franchisor's fiscal year end. This is similar to the FTC Rule's annual update requirement but differs in that an application (and fee) must be filed and, except as mentioned below, the franchisor must obtain clearance from the state before the updated FDD may be used for franchise sales activities.

The following states assign expiration dates based on a fixed registration period or one-year anniversary date:

Indiana  
Maryland  
Michigan  
North Dakota

South Dakota  
Virginia  
Washington  
Wisconsin

In these states, at least two updates per year may be necessary (once within 120 of the franchisor's fiscal year-end and again at the time of renewal). However, by submitting renewal applications early, and requesting a revised annual expiration date, over time many franchisors have had their expiration dates in the above states adjusted to fall within the FTC's 120 day annual update period.

States requiring renewal or annual reports within 90 – 120 days after the close of the franchisor's fiscal year are:

California (110 days)	Minnesota (120 days)
Hawaii (90 days)	New York (120 days)
Illinois (120 days)	Rhode Island (120 days)

**b. Effectiveness of Renewed and Amended FDD**

The franchisor must also pay proper attention to the date on which it is authorized by the state to use the updated FDD filed in connection with a timely renewal application. In some registration/disclosure states, a franchisor must cease offering and selling franchises until the state has approved the updated FDD. This is sometimes referred to as "going dark" in a particular state. These states view the previously registered FDD as out-of-date once an amended FDD is filed.

However, as noted below, in limited circumstances some states permit use of the previously registered FDD while the updated FDD is under consideration by the state.

The following list summarizes the manner in which the registration/disclosure states assign effective dates to the amended FDD filed as part of a renewal application:

- **California** -- If the renewal application is submitted at least 15 days prior to the expiration date, and if no stop order in effect, automatic renewal occurs at 12 noon on the date on which the prior registration is due to expire.
- **Hawaii** – Seven days after filing the amended FDD with the state.
- **Illinois** – Upon receipt by the Administrator. If deficiencies are noted later by the Administrator, however, use of the amended FDD must cease and any prospective franchisees must be redisclosed with a corrected and approved FDD.
- **Indiana** – On the annual expiration date.
- **Maryland** – If the renewal application is made in a timely manner (See MD Regulations § 2.02.08.07A), on the annual effective date. If not timely filed or deficiencies are found, Maryland will provide notification of the effective date.

*In Maryland, franchisors may continue to use the previously registered FDD while the updated FDD is pending. See MD Regulations § 02.02.08.06. Redisclosure of a prospective franchisee is required if the updated FDD is approved before the sale.*

- **Michigan** – Upon receipt.
- **Minnesota** -- Upon order of the commissioner.
- **New York** – For annual renewals that also contain an amended FDD, 15 days after submission of the updated FDD, unless deficiencies are identified and reported to the franchisor within the 15 day period.

*If certain procedures are followed with regard to prospective franchisees, franchisors may continue to offer and sell franchises in New York during the time the Department is acting on its filing. See N.Y. Comp. Codes R. & Regs tit. 13 § 200.3*

- **North Dakota** – Upon notification by the commissioner.
- **Rhode Island** – On the thirtieth business day after filing of the application or the last amendment to the application or at an earlier time ordered by the director unless the applicant requests postponement of effectiveness of the application or the director has made a good faith effort to communicate why the application does not meet the requirements of this Act.

*Offers – but not sales – of the franchise are permitted by Rhode Island while the amended FDD is pending. Franchisors are permitted to use the previously registered FDD for these offers. Once the state clears the new FDD, a marked copy showing it's changes from the prior document must be given to the prospective franchisee at least ten business days before execution of the agreement or payment of consideration. See § 19-28.1-6(h) of the Rhode Island Franchise and Distributorship Investment regulations Act.*

- **South Dakota** – Upon receipt of the renewal application by the director.
- **Virginia** – Upon notification by the Division.

*In Virginia, a franchisor may select the effective date of the updated FDD by submitting an optional Affidavit of Compliance (Form E). In the affidavit, the franchisor formally certifies it is not insolvent (as defined by Virginia statute) and its FDD is in compliance with Virginia's disclosure regulations. If material deficiencies are later found by the Division, prospective franchisees must be redisclosed with a corrected FDD.*

- **Washington** -- 15 days after filing or the filing of last amended FDD; if deficiencies are identified, staff will request a waiver of automatic effectiveness, in which case the effective date is determined by the administrator.
- **Wisconsin** – Upon receipt

A note of caution: The effective dates described above will generally not apply if the state has begun a stop order or cease and desist proceeding against the franchisor or a principal of the franchisor.

**c. Information to be Updated at Renewal**

Franchisors that renew their state registrations with 90 – 120 days after their fiscal year must always make certain updates to their FDD. These are litigation updates (as described in Item 3), new audited financial statements (Item 21), and updated outlet and franchisee information (Item 20). In addition, the following items are most likely to change as of the end of the franchisor's previous fiscal year:

- Company history (Item 1)
- Officers and directors (Item 2)
- Initial and other fees (Items 5 & 6)
- Total initial investment (Item 7)
- Revenues from required franchisee purchases (Item 8)
- Financing terms (Item 10)
- Advertising and computer costs (Item 11)
- Trademarks (Item 13)
- Financial performance representations (Item 19)
- Contract changes

**d. Financial Statements Updates at Renewal**

Franchisors that renew their registration within 90 – 120 days after the close of their fiscal year must include their new audited financial statements in the updated FDD. If the franchisor's expiration date is more than 90 – 120 days from the end of its fiscal year, the new audited financial statements may need to be supplemental with unaudited financial statements dated within 90 – 120 days of the date the renewal application is submitted.

If the new financial statements contained in the renewal application fail to demonstrate that the franchisor has sufficient financial strength to provide promised pre-opening obligations and services, a state may require a financial assurance condition (escrow, fee deferral, guarantee, etc) in order to renew the registration.

At the time of renewal, upon request most states will revisit the need for an existing financial assurance arrangement to remain in place. However, absent a clear and justifiable reason, a franchisor should not assume that a financial assurance is no longer necessary and arbitrarily remove it from the franchise offering documents.

e. **Tips for Faster Renewal**

1. **Blacklining of the Amended FDD**

Careful attention should be paid to accurately and completely marking changes in the revised FDD. If an examiner notices something that is not marked, the examiner may decide that the entire document should be reviewed rather than only the blacklined changes

2. **Submitting Old Version of the FDD**

There is no better way to draw intense scrutiny of an FDD than to file a version where certain disclosure has previously been noted as deficient by the state. This throws into doubt whether the franchisor ever really corrected the deficiencies and may lead to questions about exactly what the franchisor has been giving prospective franchisees.

3. **Financial Assurances**

If the franchisor anticipates that a financial assurance will be required, it should consider including it in its renewal application from the outset.

4. **Removal of Financial Assurance**

If a financial assurance condition is in place for an existing registration, do not remove it from the updated FDD without a clear reason or checking with the state first.

5. **Issuance Date**

Failing to include an updated issuance date on the FDD (or confusing the issuance date with the state effective date).

6. **Initial Investment Totals**

Make sure total initial investment estimates on the cover page and in Item 7 match.

7. **Item 7 Table**

Any dollar amount changes should also be reflected in the table totals so the columns add correctly.

8. **Royalty and Fee Changes**

Any initial fee, royalty fee, and other fee changes in the FDD should also be changed in franchise agreement, if applicable.

9. **Revenue from Required Purchases**

In Item 8, revenues received from required franchisee purchases should be from the latest fiscal year.



## 10. Guarantee of Performance

If applicable, the franchisor must include a copy of the current version of a guarantee of performance in the FDD.

### IV. AMENDMENTS

An FDD is not carved in stone at its creation. It evolves over time, with revisions made at a minimum once each year when a franchisor prepares an annual update (or renewal). But putting aside the annual update (which is described in Section II of this paper), what would cause a franchisor to revise its FDD on an interim basis? And how can it complete the interim update in a timely and efficient manner? While the franchise registration states are the key concern with respect to these inquiries, the FTC Rule is also important. No filings are made with the FTC, but the rules for amending an FDD are an important feature of the FTC Rule. Whether under federal or state law, a franchisor must establish sound and effective policies for evaluating the need for an amendment and then, if required, take the necessary steps to process the FDD changes and state filings.

#### a. When Is Amendment Required?

There is no absolute standard for determining when an FDD amendment is required. What is clear is that there is a difference between the FDD changes to be made at the annual update versus the changes to be made via amendment.

The FTC Rule states that, with respect to the annual update: “All information in the [FDD] shall be current as of the close of the franchisor’s most recent fiscal year” (emphasis added).<sup>1</sup> The FTC Compliance Guide likewise states that the FDD must be updated after the fiscal year end “to ensure that the document is current.”<sup>2</sup> Thus, it is clear that the entire FDD must be reviewed on an annual basis and updated “from stem to stern.”

The FDD amendment requirements of the FTC Rule are as follows: “The franchisor shall [on a quarterly basis] prepare revisions to be attached to the disclosure document to reflect any material change to the disclosures included or required to be included, in the disclosure document.”<sup>3</sup> Accordingly, an amendment is intended to capture only material changes, if any, and not a comprehensive revision of the FDD. The FTC implicitly recognized the limited nature of amendments by noting that: (a) some FDD items require annual updates only (e.g., certain information in Items 8 and 11) and thus would not be the subject of quarterly amendments; and (b) if there is a material change in the information presented in the audited annual financial statements, such changed information can be reflected in a quarterly amendment via the use of unaudited financial statements.<sup>4</sup>

If an amendment is triggered only by a “material change,” how is that term defined? The FTC Rule is silent on the issue although the original version of the Franchise Rule defined “material,” “material fact” and “material change” to include:

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<sup>1</sup> 16 CFR 436.7(a)

<sup>2</sup> Bus. Franchise Guide (CCH) ¶ 6086, p. 9129-263

<sup>3</sup> 16 CFR 436.7(b)

<sup>4</sup> Bus. Franchise Guide (CCH) ¶ 6086, pp. 9129-263, 264