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

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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 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 to 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	South Dakota
Maryland	Virginia
Michigan	Washington
North Dakota	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).[1] The FTC Compliance Guide likewise states that the FDD must be updated after the fiscal year end "to ensure that the document is current."[2] 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."[3] 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.[4]

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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1 16 CFR 436.7(a)

2 Bus. Franchise Guide (CCH) ¶ 6086, p. 9129-263

3 16 CFR 436.7(b)

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

> "[A]ny fact, circumstance or set of conditions which has a substantial likelihood of influencing a reasonable franchisee or a reasonable prospective franchisee in the making of a significant decision relating to a named franchise business or has any significant financial impact on a franchisee or prospective franchisee."[5]

State franchise laws follow a similar path but, in some cases, provide specific examples of events constituting a material change. For example, the regulations to the Minnesota franchise law contain one of the more comprehensive lists of exemplars of events constituting a material change, as follows:

Material event" or "material change" shall include, but not be limited to, the following:

1. the termination, closing, or failure to renew by the franchisor during any consecutive three-month period after registration of ten percent of all franchises of the franchisor, regardless of location, or ten percent of the franchises of the franchisor located in the state of Minnesota;

2. any change in control, corporate name, or state of incorporation, or reorganization of the franchisor;

3. the purchase by the franchisor during any consecutive three-month period after registration of ten percent of its existing franchises, regardless of location, or ten percent of its existing franchises in the state of Minnesota;

4. the commencement of any new product, service, or model line involving, directly or indirectly, an additional investment in excess of 20 percent of the current average investment made by all franchises or the discontinuation or modification of the marketing plan or marketing system of any product or service of the franchisor where the average total sales from such product or service exceed 20 percent of the average gross sales of the existing franchisees on an annual basis;

5. any change in the franchise fees charged by the franchisor; or

6. any significant change in:

   a. the obligations of the franchisee to purchase items from the franchisor or its designated sources;

   b. the limitations or restrictions on the goods or services which the franchisee may offer to his customer;

   c. the obligations to be performed by the franchisor; or

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5 Bus. Franchise Guide (CCH) ¶ 6192(n)

d. the franchise contract or agreement, including all amendments thereto.[6]

Some of the items listed are entirely sensible but others do not appear to fit the common understanding of materiality. For example, it hardly seems appropriate to classify as material a franchisor's reincorporation from Illinois to Delaware. Similarly, the repurchase or termination of the only, or one of the few, units in Minnesota should not automatically be treated as material.

While it is impossible to compile all of the possible occurrences, actions and events that would necessitate an amendment, they can be placed in three general categories:

1. Franchise agreement changes; for example, a fee increase or discount, or a change in territorial rights.

2. 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"). Additions to the FDD; for example, the inclusion of a financial performancerepresentation or the establishment of a new lending program.

3. Changes to existing FDD disclosures; for example, a corporate restructure, an acquisition or divestiture, personnel changes, the filing of litigation or updates to litigation, initial investment modifications or sourcing program changes.

Some might argue that there should be a fourth category encompassing material changes that do not fall within the disclosure items specified in the FDD. While this may be theoretically possible, it is difficult to envision the types of events or actions that would fall within this category. For example, is a franchisor required to point out in an FDD that an economic recession might affect a franchisee's business prospects? Or are there some common occurrences or widely-known conditions about which a franchisee should be expected (as a "reasonable" investor) to have knowledge? Note the FTC's express prohibition of the inclusion of "any information that is not required or expressly permitted, either by the amended Rule itself or by state law."[7] The FTC's position also supports an argument that extraneous information (i.e., information outside the scope of the FDD items) should be excluded because, in part, it is difficult to establish the relative priority of the infinite variety of such information.

The decision on whether or not to amend the FDD is a complex one. While some may opt to err on the side of treating all changes as material, that position may result in deferred or lost franchise sales. Also, because amendments usually require redisclosure and cooling-off periods, it increases the likelihood of technical violations and other problems. On the other hand, ignoring material changes until the next annual update creates legal risks, whether from governmental enforcement or private actions.

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[6] Minnesota Rules, Section 2860.2400

[7] 16 CFR 436.6(d)

b. Timing of Amendment

Under the FTC Rule, any necessary amendments are to be made on a quarterly basis (although the FTC allows more frequent amendments if desired). Typically, amendments are implemented during the month following the franchisor's fiscal quarter.

The rules are different with respect to material changes to a franchisor's Item 19 presentation. Rather than quarterly updates, the FTC determined that a franchisor must "notify the prospective franchisee of any material changes that the [franchisor] knows or should have known occurred in the information contained in any financial performance representation in Item 19…"[8] In basic terms, this means that a franchisor must monitor any changes in its Item 19 data and, if material, notify prospects of such changes. While this sounds relatively straightforward, implementation could be somewhat difficult. For example, if a franchisor uses accurate historical data in Item 19, is there an obligation to revise Item 19 when current data indicates a trend varying from the historical information? It may be a question of degree but, in all likelihood, the FTC would answer in the affirmative.

The FTC's sensible quarterly updating requirement (for changes other than those affecting financial performance representations) does not necessarily apply in all 50 states. Some of the franchise regulatory states have differing amendment timing requirements and they require filings and/or disclosure to the prospect as follows:

California	promptly (after a material change)[9]
Hawaii	prior to any additional franchise sale[10]
Maryland	promptly[11]
Minnesota	within 30 days[12]
New York	promptly[13]
North Dakota	promptly[14]
Rhode Island	promptly[15]
Virginia	upon the occurrence of a material change[16]

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[8] 16 CFR 436.7(d)

[9] Cal. Corp. Code, Section 31123

[10] Hawaii Rev. Stat., Section 482E-3(b)

[11] Maryland Stat., Section 14-220

[12] Minnesota Stat., Section 80C.07

[13] N.Y. Gen. Bus. Law, Section 683.9(a)

[14] N.D. Century Code, Section 51-19-07

[15] R.I. Gen. Laws, Section 19-28.1-11

[16] Va. Admin. Code, Section 5-110-40

Washington	as soon as reasonably possible and in any case before the further sale of any franchise[17]
Wisconsin	within 30 days[18]

As should be apparent, these varying requirements are difficult to reconcile and in some cases even harder to implement. For example, how does a franchisor comply with Virginia law and file an amendment "upon the occurrence" of a material change? What is clear is that the FTC's quarterly updating requirement may be subject to the stricter standards, however vague and nebulous, of the states listed above.

In addition, two of the states have created some degree of flexibility in connection with the amendment process. California allows franchisors to continue to offer, but not to sell, franchises while the franchisor awaits approval of its amendment application. To take advantage of this right to continue offering franchises, the franchisor must provide to the prospect: (1) the FDD filed with the state; (2) a statement that the FDD has been filed but has not been reviewed and is not yet effective; and (3) prior to the sale, the final effective FDD (i.e., which incorporates any of the state's comments on the filing) and a description of the material differences between the filed FDD and the final FDD.[19]

New York goes a step further and even allows a sale to take place while an amendment application is under review, albeit with some unappealing collateral requirements.[20] In order to qualify for this process, a franchisor must inform the prospect that its FDD has been submitted for review by the state. If the franchise sale occurs, the funds paid by the prospective franchisee must be held in trust until the prospect receives and has had an opportunity to review the final registered FDD. The prospect then has an opportunity to rescind the purchase, in which case the transaction is unwound and the funds are repaid. Also, if the state never approves the FDD, the transaction is rescinded and the prospect is refunded all monies paid.

c. <u>How to Implement an Amendment</u>

Once a decision has been made to amend an FDD and it is an appropriate time to do so, how does a franchisor carry out the process?

The FTC appears to favor amendment via an attachment to the FDD, but there is no reason to believe that the FTC would prohibit interlineal changes within the FDD itself. Naturally, because an FDD is not filed with the FTC, any amendment can be incorporated without any waiting period. But the FTC has some unique rules on delivery of an amended FDD that contrast with the state requirements.

Under the FTC Rule, a prospective franchisee must receive the current FDD (i.e., the version most recently updated within 120 days after the franchisor's fiscal year end), along with the most recent quarterly update, if any.[21] But this delivery requirement only applies to the initial disclosure to a prospective franchisee. If a franchisor updates its FDD (either an annual or a

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[17] Wash. Rev. Code, Section 19.100.070(3)

[18] Wis. Stat., Section 553.31

[19] Cal. Corp. Code, Section 31108

[20] N.Y. Regulations, Section 200.3(h)(3)

[21] 16 CFR 436.7(b)

quarterly update) after the initial disclosure to the prospect, it is not obligated to redisclose to that prospect. However, the franchisor must provide all updates (since the original date of disclosure) if the franchisee makes a reasonable request for them. In this context the word "reasonable" probably means that a request must be honored if there have been any updates and the franchisor continues to offer franchises. In addition, there is a twist on the timing of the updates. A franchisor need not provide the update at least 14 days before contract signing or payment of consideration. Instead, the update must be provided a "reasonable time" before the franchise agreement is signed, which presumably means something less than 14 days in advance.

The state laws vary considerably from the FTC Rule. In most cases, if an amendment is required, it must be filed with the state regulator and the franchisor must await state approval. This would exclude states where amendment filings are not required, such as Indiana, Michigan and South Dakota, and states where the amendment is effective upon filing, such as Illinois and Wisconsin (although in Illinois, comments may be provided after the filing, in which case the amendment is in suspense until the franchisor responds to the comments).

In addition, most states mandate that the franchisor redisclose all prospective franchisees in the "pipeline" and wait the normal 14-day cooling-off period until the sale can be consummated. For example, the Illinois law is typical with respect to this requirement:

> The franchisor shall deliver the amended disclosure statement in accordance with the requirements of...this Act to any prospective franchisee including prospective franchisees to whom a disclosure statement was previously delivered if the material change relates to or affects the franchise offered to such prospective franchisees.[22]

An interesting side issue here, which is reflected in the Illinois law, relates to the vehicle used to convey the amended information. As described earlier, the FTC seems to prefer an addendum to the FDD to cover the amended information. On the other hand, the states appear to require the delivery of a full FDD, which would include the amended information as interlineal changes. None of the states require that these interlineal changes be marked in any way to facilitate the prospect's review of the amended items. In this respect, the FTC-preferred addendum would seem to be a better method to focus the reader's attention on any amended information.

Finally, notwithstanding the technical requirements of state law, some franchisors will use a form of "self-help" and simply notify all prospective franchisees of amended information and forego any filings with the states. This may be done to avoid delays in the state reviews and to start the clock running on the 14-day cooling-off period. This certainly is not sanctioned by any of the state regulators (unless the amended information could be viewed as a non-material change) but it does have the effect of putting prospects on notice of the amended information, thereby potentially ameliorating the risks of a fraud-based private action in the future.

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[22] 815 ILCS 705/11

d. The California Aberrations

While not falling strictly under the topic of amendments, it may be of interest to briefly summarize two oddities under the California Franchise Investment Law – negotiated changes and material modifications.

The FTC Rule and most other state franchise laws encourage negotiations between franchisor and franchisee. While California law does not expressly contradict this position, the law indirectly inhibits negotiations by requiring that a franchisor jump through various hoops if it ever negotiates any aspect of a franchise offer. Section 31109.1 of the California law establishes the procedures for dealing with negotiated changes, which are treated as exceptions to the rule that only the franchise terms registered with the state can be offered to franchisees.[23] (It may make sense for the California regulators to take a negative view of changes to franchise terms that solely favor the franchisor (i.e., a variant on the bait-and-switch device) but this provision applies to all changes, even those that wholly favor the franchisee.) Thus, unless there is an exemption like Section 31109.1, the law would require an amendment filing on every occasion that a franchisor negotiates any term with a franchisee. Basically, Section 31109.1 mandates that a franchisor:

1. provide a prospect with a summary of all terms that have been negotiated in the last 12 months;

2. at the prospect's request, provide the specific previously negotiated terms;

3. file with the DOC a notice of negotiated sale that describes the negotiated change; and

4. certify in its renewal filing that it has complied with these requirements.

In addition, any negotiated changes must "on the whole, confer additional benefits on the franchisee."

The unintended end result of this misguided regulation is that franchisors often refuse to negotiate with California franchisees. While it is improper to state that it is "illegal" to negotiate, it is entirely appropriate for a franchisor to reject negotiations because of the complications and red tape associated with the California law. Alternatively, a franchisor may amend its FDD to encompass, in broad ranges, the types of issues that may be negotiated to avoid the need for filing notices of negotiated changes and then providing the lists of negotiated changes to future prospects.

Perhaps even worse is the material modification process contained in Section 31125 of the law, which is somewhat out of place in a statute that principally regulates offers to prospective franchisees.[24] This provision essentially requires disclosure to existing franchisees if the franchisor proposes to change any terms of the franchise agreement. (For some unknown reason, the California legislature ignored the fact that a change to an existing contract can only be effectuated by the voluntary agreement of both parties.) If a franchisor desires to implement

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[23] Cal. Corp. Code, Section 31109.1

[24] Cal. Corp. Code, Section 31125

a modification, it must file a description of the modification with the state and then allow a franchisee a cooling-off period (or a rescission period) during which the franchisee can consider the proposed revision. Alternatively, there are various exemptions to the normal process, the most prominent of which exempts a voluntary offer which does not adversely impact the franchisee's rights and obligations. Of course, this exemption may be unavailable if any aspect of the negotiated transaction, however minor or inconsequential, favors the franchisor.

In any event, the need for this type of legislation is quite unclear and it further complicates and impedes a franchisor's business activities in California.

V. EXEMPTIONS

Anyone who has flown in coach class on an airline in the United States in the last 10 years probably knows the pain and frustration of waiting in line to be screened by security. The security screening is – at least in principle – a good thing. It helps to keep us safe, so we tolerate it. But, it is hard not to be envious as passengers in first class move practically effortlessly to a dedicated lane with virtually no wait and are zipped through the process in a fraction of the time. For many franchisors, the process of obtaining, amending and renewing their state franchise registrations is a lot like standing in an airport security line. For them, to be exempt from a state's registration process is the equivalent of getting a pass into the first class lane.

In the best of circumstances, a state franchise exemption may allow a franchisor to be able to offer and sell franchises in the state much faster than they would if they had to file a full franchise registration application – sometimes less expensively. The biggest problem with franchise exemptions is that there is little uniformity from state to state in the eligibility and filing requirements. The lack of uniformity can necessitate a close evaluation of each state's requirements for the exemption and additional administrative attention to maintain compliance.

This section will identify the types of exemptions that are generally useful to franchisors in managing their state franchise filing[25] obligations and highlight the definitional nuances that may apply in the states that recognize each exemption type. Also, because filing requirements (and deadlines) may be different for a particular exemption than the state's franchise registration requirements, this section will address the extent to which each exemption is subject to special rules.

a. State Exemptions

There is great variety in what exemptions a state may recognize, what must be done for a franchisor or a transaction to be deemed exempt from franchise registration in a state, and what must be done in the future for that transaction or franchisor to remain exempt in that state. While some states may require a filing for a sale of a franchise to someone who qualifies as an insider of the franchisor, other states automatically exempt it and require no filing. Even for exemptions that are ostensibly similar, the states use different criteria for a franchisor, franchisee, or transaction to qualify for the exemption. While a franchisor may qualify as a large franchisor and be exempt in one state, the franchisor may not have enough business experience to qualify for the same exemption in another state.

[25] As most franchise law practitioners know, franchisors often must make filings under other state statutes usually referred to as "Business Opportunity Laws." These filings are beyond the scope of this section.

The states also distinguish between exemptions from registration and exemptions from disclosure. If a franchisor is exempt from registration, it does not have to file a full franchise registration application with the state agency. But, exemption from registration does not relieve a franchisor of its obligation to provide prospective franchisees with a franchise disclosure document. If a franchisor (or a transaction) qualifies for an exemption from disclosure, the franchisor does not need to provide a franchisee with a disclosure document (under state law). Unless otherwise indicated, the exemptions described apply to exemption from registration only.

Conceptually, it is helpful to think of the various exemptions as falling into 3 main categories. Exemptions may be based on: (1) characteristics of the franchisor, (2) the nature of the transaction, or (3) characteristics of the franchisee. Of course, not all available exemptions fall neatly into these categories, but the ones that do not are generally not particularly useful to a typical franchisor in planning their compliance program. Brief discussions of the exemptions most likely to be useful to a typical franchisor are provided below. The state-specific requirements for each exemption are discussed in Section III, below. A chart that identifies each category of exemption and the states that recognize them is attached as Appendix B to this paper. A chart summarizing the requirements for filing each of the exemptions discussed below is attached as Appendix C.

1. Exemptions Based on Franchisor's Characteristics

a. Large Franchisor Exemption

Several states provide exemptions from franchise registration for franchisors that have substantial net worth and/or experience in franchising. The apparent justifications for this exemption are that (i) a franchisor with substantial net worth is likely to have assets that can be used to pay a judgment in the event that the franchisee has a legal claim against the franchisor, and (ii) the franchisor's track record is substantial enough to expose any concerns a franchisee may have about the viability of the business or the franchisor's ability to run it. A "large franchisor" may be defined by state law by its net worth alone or by its net worth coupled with its business experience. There is usually a threshold amount for the franchisor's net worth, such as $5 million, but the threshold amount varies substantially by state. Most states also include a provision where the franchisor may have a lower net worth than the general threshold if a parent of the franchisor meets the higher threshold for net worth. In these cases, some states require the parent to guarantee the franchisor's duties and obligations. If a state includes a business experience requirement to be exempt, it may require that the franchisor have been in business for a set amount of time, have a certain number of franchisees, have conducted the type of business that is the subject of the franchise, or have a parent that fits those categories.

b. Cooperative Organizations Exemption

Cooperative organizations are generally organizations operated for independent retailers. The members usually own equal shares in these organizations and membership itself is limited to people who will directly benefit from the services the organization provides.

2. Exemptions Based on the Nature of the Transaction or Franchise System

a. Limited Offer Exemption

Some states provide an exemption for transactions arising in situations where the franchisor has not actively solicited franchises for sale in the state. Generally, the sale of a limited number of franchises (one or two) within a certain time period, when the franchisor has not advertised the sale, may be exempt. This exemption is often useful in situations where a franchisor is contacted by a prospect in a state in which the franchisor does not have a general intention to expand. If the transaction is exempt, the franchisor can pursue the opportunistic sale without having to spend the time and effort needed to obtain a registration.

b. Fractional Franchise Exemption

A fractional franchise may exist when the putative franchised business is expected to represent a small portion of an existing business. Generally, a fractional franchise exists where the putative franchised business will account for 20% or less of the existing businesses' sales in the first year. Some states will also require that the putative franchisee have a certain amount of experience in a related business for the transaction to qualify as the sale of a fractional franchise.

c. Minimum Payment Exemption

A business which would otherwise be a franchise but requires a nominal payment, such as less than $500, may be either excluded from the definition of a franchise or exempt from the registration and disclosure requirements.

d. Large Initial Investment Exemption

If the initial investment made by a franchisee is large, the state may presume that if the franchisee can afford the payment, the franchisee must have enough business experience to assess the risks and benefits of the franchise investment and does not need the protection of the franchise laws. Note that this exemption is similar to the Large/Experienced/Seasoned Franchisee exemption discussed below.

e. Extension, Renewal, Modification, or Amendment of Franchise Agreement Exemption

There may be an exemption when a franchise agreement is extended, renewed, modified or amended and there is neither an interruption in the operation of the franchised business, nor a material change in the agreement.

3. Exemptions Based on Franchisee's Characteristics

a. Large/Experienced/Seasoned Franchisee Exemption

A franchisee with a large net worth and/or significant experience in the business to be franchised are very likely — in theory — to take their due diligence seriously and/or consult with knowledgeable advisors before signing a franchise agreement. So, some states exempt transactions involving these franchisees from registration.

b. Insider Exemption

Certain people who have intimate knowledge of the operations of the franchisor are often presumed to be in a position that would not benefit greatly from the additional protections that a state agency's review of a franchise registration may provide. These "insiders" are usually defined as persons who own at least a 50% interest in the prospective franchisee and for at least the previous two years have been an officer, director, or owner of an interest in franchisor.

4. Other Exemptions

a. Exemption by Order

Many states allow the state agency responsible for enforcing the franchise registration law to grant exemptions when registration is not necessary to protect prospective investors and is not in the public interest. This may be called an "exemption by order." An exemption by order is an individualized ruling that generally requires that a franchisor articulate a specific explanation of why the sale of their franchises should be exempt.

b. Miscellaneous Exemptions

There are several other exemptions that states may recognize, but most are of little practical impact for traditional franchisors in managing their state sales compliance process. They are mentioned here and are noted in the overview chart attached as Appendix A, but are not included in the following state-by-state review. The "leased departments" exemption covers businesses operating within a retail establishment, such as a department or division, that is not required to purchase goods or services from the retail operator. A few states specifically exempt the sale of securities from the franchise laws. Franchise sales by a sheriff, executor, administrator, marshal, receiver, trustee in bankruptcy, guardian or conservator are often exempt. The sale of a franchise to a bank, savings institution, trust company or insurance company often does not require registration. A few states exempt bank credit card plans which are credit cards issued by a bank. Petroleum franchises are often exempt from the requirements of the franchise laws as other state and federal laws specifically apply to them. The sale of motor vehicle dealerships may be excluded from the definition of a franchise or may be exempt from registration and/or disclosure requirements. The sale of a cable telecommunications business by a governmental entity may not require registration. If there is no written document with any of the material terms of the franchise agreement, registration and disclosure may not be required. Finally, a franchisee who offers or sells a franchise for his own account, when the sale is not effected by the franchisor, may be exempt from registration and disclosure. California allows the sale of franchises once an application has been filed with the state even though the franchise may not yet be registered. Some states will allow an exemption when the franchisee will not operate the business in that state and is not a resident of that state. The sale of an additional franchise to a franchisee currently operating the same type of franchise may be exempt from registration and/or disclosure.

B. State Exemptions and Variations

1. California

a. Large Franchisor Exemption

The large franchisor exemption in California exempts a transaction from registration and some disclosure,[26] but the franchisor must file an annual notice with the state and pay a fee.[27] To qualify for this exemption, (i) the franchisor must have a net worth of at least $5 million, on a consolidated basis, (ii) the franchisor must have a net worth of $1 million and a company owning at least 80% of the franchisor (a "Parent") must have a net worth of at least $5 million, or (iii) the franchisor must have a net worth of at least $1 million — according to its unaudited financial statement — and the Parent must have a net worth of at least $5 million, and must guarantee to assume the franchisor's duties and obligations under the franchise agreement should the franchisor become unable to perform them.[28] Also, the franchisor or Parent, at all times during the previous five years, must have had at least 25 franchisees, or conducted the same type of business as is the subject of the franchise.[29] In California, the large franchisor exemption does not completely exempt the franchisor from disclosure. While the franchisor is not required to provide prospective franchisees with a franchise disclosure document, the franchisor must provide specific information, much of which is extensive and is very similar to what is required to be included in a franchise disclosure document, including a copy of the franchise agreement, a description of payments and fees, and a statement regarding any restrictions on from whom the franchisee may purchase products, to name a few.[30] If an existing franchise agreement is being materially modified, the disclosure must include the proposed modifications.

The required annual notice filing should be filed between July 1 and December 31 of the year before the year for which the exemption will be claimed.[31] A notice may be filed in the same year that an exemption is claimed, but the effective date will be the filing date and it will expire on December 31 of that year. A renewal notice should be filed prior to the end of the calendar year.

b. Cooperative Organization Exemption

California's Franchise Investment Law's definition of a franchise excludes nonprofit organizations operated on a cooperative basis by and for independent retailers.[32] To be excluded though, the organization must fit all of the following criteria, including: (i) substantially equal control and ownership by the members, (ii) limited membership to those who will avail themselves of the organization's services, (iii) limited or no transfer of ownership, (iv) no return on the capital investment, (v) members receive substantially equal benefits, (vi) no personal liability by the members for the organization's obligations, (vii) the organization provides services mainly for the member's use, (viii) each member receives a disclosure document, and

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26 CAL. CORP. CODE § 31101.

27 CAL. CODE REGS. tit. 10, § 310.101.

28 CAL. CORP. CODE § 31101(a).

29 CAL. CORP. CODE § 31101(b).

30 *See* CAL. CORP. CODE § 31101(c)(1).

31 CAL. CODE REGS. tit. 10, § 310.101.

32 CAL. CORP. CODE § 31005(c).

(ix) none of the organization's receipts, income or profit is paid to a for-profit entity, other than for necessary goods and services.[33] Because one of the criteria for this exemption is to provide members of the organization with a disclosure document, it only exempts the organization from registration. However, no filing with the state is required.

c. **Fractional Franchise Exemption**

California law recognizes the fractional franchise exemption when the franchise adds a new product or service line to the franchisee's existing business.[34] While this exemption releases the franchisor from both the disclosure and registration requirements, the franchisor must file a notice of exemption and pay a fee before any offer or sale. To qualify as a fractional franchise in California, all of the following must be met: (i) the prospective franchisee has been involved in a business offering products or services substantially similar to those of the franchised business for the previous 24 months, (ii) the new product or service is substantially similar or related to the products or services the prospective franchisee's business currently offers, (iii) the franchised business will be offered from the same location as the current business, (iv) at the time of the agreement establishing the franchise, both parties anticipate that the new business would not compose more than 20% of the franchisee's annual total sales, and (v) the franchisor does not control the prospective franchisee.[35]

As discussed in the Large Franchisor Exemption, the required annual notice filing should be filed between July 1 and December 31 of the year before the year for which the exemption will be claimed.[36] A notice may be filed in the same year that an exemption is claimed, but the effective date will be the filing date and it will expire on December 31 of that year. A renewal notice should be filed prior to the end of the calendar year.

d. **Minimum Payment Exemption**

An offer or sale of a franchise in California for which the initial fee is $500 or less is exempt from both registration and disclosure.[37] No filing is required.

e. **Large/Experienced/Seasoned Franchisee Exemption**

California allows for an exemption for large franchisees and a different exemption for experienced franchisees. Both exempt a franchisor from registration and disclosure.

A sale of a franchise to a large franchisee can be exempt from both registration and disclosure, provided that the franchisor files a notice of exemption and pays a fee.[38] To qualify as a "large franchisee," each purchaser of the franchise must be either: (i) a partner, executive officer or director of the franchisor, or any executive officer of its corporate general partner if franchisor is a partnership, or a manager if franchisor is a limited liability company, (ii) an entity with over $5 million in assets, but not an entity specifically formed to acquire the franchise, (iii) a

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[33] *Id.*

[34] CAL. CORP. CODE § 31108.

[35] *Id.*

[36] CAL. CODE REGS. tit. 10, § 310.101.

[37] CAL. CODE REGS. tit. 10, § 310.011.

[38] CAL. CORP. CODE § 31109(e).

person whose net worth — including joint net worth with a spouse — is more than $1 million, (iv) a person whose income exceeds $300,000 per year in the prior two years, or whose joint income with a spouse exceeds $500,000 per year in the prior two years, and the person or spouses have a reasonable expectation of receiving at least the same income in the current year, or (v) an entity of which all equity owners fit the qualifications described in sections (i) through (iv).[39] Each purchaser of the franchise must also have knowledge and experience in financial and business matters to the extent that the franchisor believes they can adequately evaluate the risks of the investment.[40] The purchase must be conducted with the intent to operate the franchise and not to resell the franchise.[41] The initial cash fee cannot exceed 10% of the purchaser's net worth, if the purchaser is a natural person.[42] Finally, the law makes clear that this exemption may not be used as a plan to avoid registration — the franchisor or its officers, directors, employees or agents may not form, organize, engage or assist anyone to purchase a franchise for resale or distribution to qualify for an exemption.[43] As with California's Large Franchisor Exemption, the required annual notice filing should be filed between July 1 and December 31 of the year before the year for which the exemption will be claimed.[44] A notice may be filed in the same year that an exemption is claimed, but the effective date will be the filing date and it will expire on December 31 of that year. A renewal notice should be filed prior to the end of the calendar year.

The sale of a franchise to an "experienced franchisee" may also be exempt from registration and disclosure in California. An experienced franchisee is one where any one of the following apply: (i) at least one owner of at least a 50% interest in the prospective franchisee, in the prior seven years had at least 24 months of responsibility for both financial and operational aspects of a business that is substantially similar to the franchised business and the owner is not controlled by the franchisor, (ii) at least one owner of at least a 50% interest in the prospective franchisee, within the previous 60 days has had at least 24 months of experience as an officer, director, managing agent or owner of at least a 25% interest in the franchisor, or (iii) the sale is to an existing franchisee, or an entity of which an officer, director, managing agent or owner holds at least a 25% interest in a current franchisee, as long as in either case the entity or person, for at least 24 months, has been involved in a business that is substantially similar to the franchised business.[45] To claim this exemption the franchisor must file a notice with the Commissioner of Corporations and pay a fee within 15 calendar days after the sale.[46]

f. **Insider Exemption**

An explanation of the California Insider Exemption[47] is included in the discussion of the California Large/Experienced/Seasoned Franchisee Exemption.

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39 CAL. CORP. CODE § 31109(a).

40 CAL. CORP. CODE § 31109(b).

41 CAL. CORP. CODE § 31109(c).

42 CAL. CORP. CODE § 31109(d).

43 CAL. CORP. CODE § 31109(f).

44 CAL. CODE REGS. tit. 10, § 310.101.

45 CAL. CORP. CODE § 31106(a).

46 CAL. CORP. CODE § 31106(b).

47 CAL. CORP. CODE §§ 31106(a)(2), 31109(a)(1).

2. Hawaii

a. Extension, Renewal, Modification, or Amendment of Franchise Agreement Exemption

Neither registration nor disclosure is required when (i) an existing franchise is extended or renewed, (ii) a modified or amended franchise agreement is exchanged or substituted, or (iii) the location of a franchise is transferred, but there is no interruption in the franchisee's business, and there is no material change in the franchise relationship.[48] The franchisor is not required to file anything with the state.

b. Exemption by Order

The Director of Commerce and Consumer Affairs may deem certain transactions, people, entities or industries exempt from registration and disclosure after considering if such an exemption is within the public interest and whether information which would otherwise be required to be disclosed would be material to a determination of whether a prospective franchise has a reasonable chance of success.[49] The franchisor should submit a letter explaining the reasoning for why it should be granted an exemption by order.

3. Illinois

a. Large Franchisor Exemption

Illinois recognizes two forms of "large franchisor" exemption — one with a net worth threshold of $5 million and another with a net worth threshold of $15 million.

An offer or sale made by a franchisor with a net worth of at least $15 million (or at least $1 million, if its Parent has a net worth of at least $15 million) is exempt from registration.[50] No filings with the state are required. On a practical note though, if a franchisor has previously been registered, it may be advisable to withdraw any existing registration before relying on this exemption so that the franchisor's application is not listed as "terminated" upon expiration. A terminated registration may have the effect of chilling potential franchise sales.

Alternatively, if a franchisor's net worth is at least $5 million (or at least $1 million, if its Parent's net worth is at least $5 million, and the Parent guarantees to assume the franchisor's duties and obligations under the franchise agreement in the event that the franchisor becomes unable to perform them), an offer or sale made by that franchisor may be exempt from registration.[51] To be exempt, the franchisor, its Parent or Parent of franchisor's predecessor, also must have had at least 25 franchises conducting business in the franchise system in the previous five years.[52] If the franchisor has conducted a business that is substantially the same as the franchised business, that can fulfill three years of the required experience.[53] The

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[48] HAW. REV. STAT. § 482E-4(a)(5).

[49] HAW. REV. STAT. § 482E-4(b).

[50] ILL. COMP. STAT. § 815: 705/8(a)(1).

[51] ILL. ADMIN. CODE tit. 14, § 200.202(e)(1).

[52] ILL. ADMIN. CODE tit. 14, § 200.202(e)(2).

[53] *Id.*

franchisor must still provide disclosure and the exemption will immediately terminate if the franchisor no longer meets the requirements of it.[54] To qualify for this exemption, the franchisor must submit a cover letter to the Illinois Attorney General, explaining how the net worth and experience requirements were met, and including a copy of the disclosure document, uniform consent to service of process, and a certification page.[55] This information must be submitted prior to any offer or sale. Exemption applications in Illinois receive an expedited review, but the exemption is not deemed effective upon receipt. Once the application has been reviewed and deemed effective, the exemption will be given an effective date and a termination date. The termination date is the same as the anniversary date for a franchise registration, so if a franchisor would like to continue using the exemption, an annual renewal must be filed before the termination date.

b. **Limited Offer Exemption**

See the discussion below of the Exemption by Order.

c. **Fractional Franchise Exemption**

If a franchisee has been in the same type of business as the franchised business for at least two years and at the time of the agreement both the franchisee and franchisor anticipate, or should have anticipated, that sales from their relationship would comprise no more than 20% of franchisee's sales in the first year operating the franchised business, there is no registration or disclosure required.[56] No filing with the state is required for this exemption.

d. **Minimum Payment Exemption**

Under the Illinois Franchise Disclosure Act of 1987, the definition of "franchise" only includes agreements under which a franchise fee of $500 or more is required.[57] Therefore, transactions requiring a fee of less than $500 are not subject to either the franchise registration or disclosure laws.

e. **Large Initial Investment Exemption**

See the discussion below of the Exemption by Order.

f. **Extension, Renewal, Modification, or Amendment of Franchise Agreement Exemption**

An offer or sale involving an extension or renewal of an existing franchise or the exchange or substitution of a modified or amended franchise agreement, that includes no interruption of the operation of the franchised business is exempt from registration and disclosure.[58] No filing with the state is required.

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[54] ILL. ADMIN. CODE tit. 14, § 200.202(e)(3)–(4).

[55] ILL. ADMIN. CODE tit. 14, § 200.202(e)(5).

[56] ILL. COMP. STAT. § 815: 705/3(1)(ii).

[57] ILL. COMP. STAT. § 815: 705/3(1)(c).

[58] ILL. COMP. STAT. § 815: 705/7.

g. **Large/Experienced/Seasoned Franchisee Exemption**

An offer or sale to a franchisee, its Parent or its affiliates, who has been in business at least five years and has a net worth of at least $5 million is also exempt from registration, but not disclosure.[59] There is no required filing with the state.

h. **Insider Exemption**

If one of the purchasers of at least a 50% ownership interest in the franchise has been an officer, director, general partner, individual with management responsibility for the offer and sale of the franchisor's franchises, the administrator of the franchised network, or has been an owner of at least a 25% interest in franchisor, for at least two years, an offer or sale to that person is exempt from registration.[60] The franchisor does not need to file anything with the state.

i. **Exemption by Order**

By order, the Illinois Attorney General may limit what disclosures are required for certain classes of franchises when in the public interest.[61]

A franchisor that plans to sell only one or two franchises within the following year is likely able to use this exemption, but the exemption is discretionary. Also, exemption from disclosure will only be allowed if the Illinois Attorney General specifically excuses the franchisor from the disclosure requirements.[62] Illinois characterizes the exemption from registration of the sale of one or two franchises within a year as being within the public interest. To apply for an exemption by order, the franchisor should submit a cover letter describing the basis for the exemption to the Illinois Attorney General, along with a copy of the disclosure document, among other things.[63]

When an offer or sale applies to a single unit franchise for which the minimum initial investment is more than $1 million, it may be exempt from disclosure and registration.[64] The franchisor is only exempt from disclosure though if the Illinois Attorney General specifically excuses the franchisor from that requirement. The following must be submitted for consideration of this exemption: (i) a cover letter describing the basis for the exemption, (ii) a list of administrative agencies which have granted or denied exemptions or opinions, along with copies of those exemptions or opinions, (iii) a statement of the number of franchises the franchisor plans to sell in Illinois in the next 12 months, (iv) a list of all Illinois franchise sales since the most recent franchise disclosure document submitted with the exemption application, (v) the Uniform Franchise Registration Application, (vi) Supplemental Information Page, (vii) Sales Agent Disclosure Form, (viii) Uniform Consent to Service of Process, (ix) Certification

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59 ILL. COMP. STAT. § 815: 705/8(a)(2).

60 ILL. COMP. STAT. § 815: 705/8(a)(3).

61 ILL. COMP. STAT. § 815: 705/9.

62 ILL. ADMIN. CODE tit. 14, § 200.201(b).

63 ILL. ADMIN. CODE tit. 14, § 200.201 (including the list of what is required in the cover letter, how the state defines "in the public interest," and the criteria to apply for an exemption for the sale of a single unit franchise in which the minimum investment is more than $1,000,000).

64 ILL. ADMIN. CODE tit. 14, § 200.201(c).