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Assessing Materiality - What to Include and When to Amend

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I. INTRODUCTION

The Federal Trade Commission ("FTC") promulgated the original Franchise Rule in 1978 (the "Original Franchise Rule") based on its finding that franchisors were engaged in deceptive practices in the sale of franchises. Some franchise sellers failed to disclose material facts and materially misrepresented their franchise opportunities. The Original Franchise Rule and the amended Franchise Rule which followed in 2007 (the "Amended Franchise Rule") mandated the pre-sale disclosure of material information to prospective franchisees on the premise that an informed purchaser can better evaluate a franchise opportunity. The FTC evaluated various categories of information, found certain items to be material to a prospective franchisee's decision as to whether to purchase a franchise, and mandated the disclosure of this material information to prospective franchisees prior to purchase. Disclosure typically occurs in a franchise disclosure document.

Prompted by similar observations, several states (the "registration states") enacted franchise disclosure laws that embrace similar concepts of materiality. Full and accurate disclosure are the goals of these state statutes and regulations; omission and misrepresentation are the sins. In this respect, state and federal laws coincide.

In our federal system, however, it comes as no surprise that the concept of "materiality" does not enjoy a consistent definition. The issue of materiality presents challenges in preparing franchise disclosure documents in general; it may be a particularly knotty issue in the context of amendment. What facts should initially be disclosed? Does a change in circumstances rise to a level of materiality sufficient to necessitate an amendment to a franchise disclosure document? What does an amendment need to include? When and how does the amendment need to be made?

II. THE INTERPLAY OF MATERIALITY AND FRANCHISE DISCLOSURE DOCUMENTS

A. <u>The Federal "Reasonable Prospective Franchisee" Standard</u>

In the Original Franchise Rule, the FTC defined "material," "material change" and "material fact" as "any 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 which has any significant financial impact on a franchisee or a prospective franchisee." When the FTC amended the Franchise Rule in 2007, it eliminated several defined terms from the Original Franchise Rule including "material," "material fact" and "material change". In the FTC's Statement of Basis and Purpose for the Amended Franchise Rule (the "SBP"), the FTC noted that "such definitions are not necessary" and that "materiality" should be judged by looking at "long-established Commission jurisprudence. . . [because] materiality is a cornerstone concept of that jurisprudence." When interpreting Section 5 of the FTC Act, which reaches violations of the Franchise Rule, the Commission "regards a representation, omission or practice to be deceptive if: (1) it is likely to mislead consumers acting reasonably under the circumstances; and (2) it is material; that is *likely to affect consumers' conduct or decisions with respect to the product at issue.*" Accordingly, the FTC concluded that "'materiality' is determined . . . in franchise matters, by the reasonable prospective franchisee standard."

The Franchise Rule specifically prohibits a franchisor from requiring a franchisee to waive reliance on any representation made in the franchise disclosure document because *"a prospective franchisee is entitled to regard as material each and every statement in a franchise disclosure document."* Thus, a franchisor must carefully collect and disclose information to its prospects as mandated by the 23 franchise disclosure document items identified in the Amended Franchise Rule. Many of the required disclosure items are objective and should not require a materiality analysis. However, several items require the franchisor to disclose only "material" categories of information. For each of these items, franchisors will need to engage in an analysis of whether information is material and must be disclosed, keeping in mind the "reasonable prospective franchisee" standard.

The “reasonable prospective franchisee” standard clearly informed the Court's decision in *United States v. Building Inspector of America, Inc.* That civil enforcement action followed mass action by franchisees of The Building Inspector of America ("TBIA") system and the refusal of California state authorities to register TBIA's offering circular. Among the claimed deficiencies in TBIA's offering circular was the failure to disclose certain pieces of litigation. Litigation is one of the items on which disclosure depends on materiality. As might be expected, TBIA offered abundant explanations for its omission of each case; but the Court opted for the common sense standard suggested by the "reasonable prospective franchisee" standard. TBIA argued that the undisclosed litigation was immaterial because it involved amounts that were less than 15% of TBIA's assets, an economic materiality standard that was recognized in the Original Franchise Rule. Rejecting TBIA's argument, the Court wrote, "while it is true that one of the definitions of materiality contained in the UFOC requirements uses this 15% test, the principal definition merely requires that a reasonable prospective franchisee would consider it important in the making of a decision relating to the named franchise business." The Fourth Circuit applied a similar definition of materiality in a private civil action in *Rich Food Services, Inc. v. Rich Plan Corp.*

The federal/state dichotomy adds to the complexity of the materiality analysis. The FTC prohibits a franchisor from including extraneous information in its franchise disclosure document and limits the disclosures to the information required by the Franchise Rule or by state law (if not preempted by the Amended Franchise Rule). If a registration state's anti-fraud provision requires a franchisor to include all material information in its franchise disclosure document, or if a state examiner requires a particular disclosure to prevent deception by a franchisor, then the franchisor may add such information to the franchise disclosure document. In addition, if a franchisor has additional information that may be material to a prospective franchisee in evaluating its decision to purchase the franchise, the franchisor may provide that information outside the franchise disclosure document as a part of its sales process.

B. <u>Materiality Under State Law</u>

As with the Amended Franchise Rule, most state franchise registration and disclosure laws lack a definition of materiality to guide franchisors in their disclosure obligations. Anti-fraud provisions in these statutes prohibit franchisors from making untrue statements of material facts or omitting material facts that would make a statement not misleading. These statutes dovetail with the federal concept of materiality and generally apply a standard viewed through the lens of the prospective franchisee. For instance, under the Illinois Franchise Disclosure Act ("IFDA"), "[a] statement or omission of fact is 'material' within the meaning of the Act if there is a substantial likelihood that a reasonable prospective franchisee would consider it significant in making a decision to purchase or not purchase the franchise."

Materiality was a key issue in *Morris v. International Yogurt Co.*, a case in which the franchisee sought a remedy under the Washington Franchise Investment Protection Act ("FIPA") for the franchisor's failure to disclose that its "unique" yogurt mix was available to non-franchisees. No specific requirement to disclose such a fact was cited by the Court; instead the issue was whether the non-disclosure constituted a failure to disclose material facts under the FIPA. Observing that the franchise agreement described the yogurt mix as a trade secret, a "key feature of the franchise" which made the franchise valuable, the Court found the omission material because a reasonable person would consider the omitted fact important. The franchisee's claims based on failure to disclose survived dismissal. Significantly, the franchisee's subjective testimony concerning materiality—that the unique formula was important to the franchisee's investment decision—weighed significantly in the Court's decision. As such, it is apparent that the determination of materiality under the reasonable prospective franchisee standard is viewed using an objective component (the franchise agreement and other documentation) as well as a subjective component (the franchisee's understanding).

However, just because a franchisee believes or claims information is or would have been material to its decision to invest does not mean such information must be disclosed or that its non-disclosure gives rise to liability against the franchisor. The prospective franchisee in *7-Eleven, Inc. v. Spear*, set her sights on buying a 7-Eleven franchise that had operated less than a year. She received a franchise offering circular from 7-Eleven along with supplemental financial information containing "the most recently available annual averages of the actual sales, earnings and other financial performance . . . of franchised 7-Eleven stores in each Market Area in this state (excluding stores that the same franchisee did not operate for the full calendar year)." When her newly-purchased preexisting 7-Eleven store failed, the franchisee claimed a violation of the IFDA based on 7-Eleven's failure to disclose specific financial performance information related to the store she purchased. In particular, the franchisee noted that 7-Eleven had failed to disclose that her 7-Eleven store had performed below the averages set forth in the offering circular's earnings claim and failed to generate a profit. The Illinois Court considered whether a franchisor should be required to disclose the fact that particular stores offered for sale were performing below the averages set forth in an earnings claim, ultimately rejecting the franchisee's argument because 7-Eleven had disclosed everything required by the Franchise Rule: "7-Eleven was not under an obligation to disclose every piece of information that may have been material to [the franchisee's] investment decision . . . . [A] franchisor has no duty to go beyond the disclosure requirements required by the UFOC Guidelines." The prospective franchisee was told what she was receiving and what she was not, yet elected to consummate the transaction.

C. <u>Amending the FDD When There is a Material Change</u>

Determining whether an amendment to a franchise disclosure document is necessary requires an analysis of whether there has been a "material change" in any of the information presented in the franchise disclosure document. According to the FTC Compliance Guide, material changes include events such as bankruptcy filings and the filings of legal actions against the franchisor that could negatively impact the franchisor's financial condition. The reasonable prospective franchisee standard applies in making the determination of whether an event qualifies as a material change under both federal and state standards. For example, Virginia defines a material change as "a fact, circumstance, or condition that would have a substantial likelihood of influencing a reasonable prospective franchisee in the making of a decision relating to the purchase of a franchise."

1. Guidance From State Statutes

Several of the franchise registration states provide regulatory guidance in the form of examples of events that are considered material and that would necessitate an amendment filing. In evaluating the materiality of changes within the context of the state regulatory schemes, these examples may be useful; but they are not exhaustive. An analysis of a non-enumerated event's materiality must still be undertaken to determine whether a reasonable prospective franchisee would view the information as important to his or her purchase decision. Regulatory materiality guidance includes the following.

a. Hawaii

In Hawaii, a "material change" includes:

- The termination, closing, or failure to renew during any three-month period of: (A) The greater of one percent or five of all franchises of a franchisor or subfranchisor regardless of location or (B) The lesser of fifteen percent or two of the franchises of a franchisor or subfranchisor located in this State.

- Any change in control, corporate name or state of incorporation, or reorganization of the franchisor whether or not the franchisor or its parent, if the franchisor or subfranchisor is a subsidiary, is required to file reports under section 12 of the Securities Exchange Act of 1934.

- The purchase by the franchisor in excess of five percent of its existing franchises during any three-month period on a continuous basis.

- The commencement of any new product, service or model line involving, directly or indirectly, additional investment by any franchisee or the discontinuation or modification of the marketing plan or system of any product or service of the franchisor where the total sales from such product or service exceeds twenty percent of the gross sales of the franchisor on an annual basis.

b. Maryland

In Maryland, a "material change" includes:

- The termination, in any manner, of more than ten percent of the franchises of the franchisor that are located in Maryland during any three-month period;

- The termination, in any manner, of more than five percent of all franchises of the franchisor regardless of location during any three-month period;

- A reorganization of the franchisor;

- A change in control, corporate name, or state of incorporation of the franchisor;

- The commencement of any new product, service, or model line requiring, directly or indirectly, additional investment by any franchisee; and

- The discontinuation or modification of the marketing plan or system of any product or service of the franchisor which accounts for at least twenty percent of the annual gross sales of the franchisor.

c. **Minnesota**

In Minnesota, a "material change" includes:

- 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;

- Any change in control, corporate name, or state of incorporation, or reorganization of the franchisor;

- 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;
- The commencement of any new product, service, or model line involving, directly or indirectly, an additional investment in excess of twenty 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 twenty percent of the average gross sales of the existing franchisees on an annual basis;

- Any change in the franchise fees charged by the franchisor; or

- Any significant change in: (1) the obligations of the franchisee to purchase items from the franchisor or its designated sources; (2) the limitations or restrictions on the goods or services which the franchisee may offer to a customer; (3) the obligations to be performed by the franchisor; or (4) the franchise contract or agreement, including all amendments thereto.

d. **New York**

In New York, a "material change" includes:

- The termination, closing, or failure to renew; during a three month period, of the lesser of ten or ten percent of the franchises of a franchisor, regardless of location.

- A purchase by the franchisor in excess of five percent of its existing franchises during six consecutive months.

- A change in the franchise fees charged by the franchisor.

- Any significant adverse change in the business condition of the franchisor or in any of the following: (i) the obligations of the franchisee to purchase items from the franchisor or its designated sources; (ii) limitations or restrictions on the goods or services which the franchisee may offer to its customers; (iii) the obligations to be performed by the franchisor; (iv) the franchise contract or agreements, including amendments thereto; (v) the franchisor's accounting system resulting [in] a five percent or greater change in its net profit or loss in any six month period; or (vi) the service, product, or model line.

- Audited financial statements of the preceding fiscal year.

e. <u>Wisconsin</u>

In Wisconsin, a "material change" includes:

- The termination, closing or failure to renew during any three month period of 1) the greater of one percent or five of all franchises of a franchisor regardless of location or 2) the lesser of fifteen percent or two of the franchises of a franchisor located in the state of Wisconsin.

- Any change in control, corporate name or state of incorporation, or reorganization of the franchisor whether or not the franchisor or its parent, if the franchisor is a subsidiary, is required to file reports under section 12 of the securities exchange act of 1934.

- The purchase by the franchisor in excess of five percent of its existing franchises during any three-month period on a running basis.

- The commencement of any new product service or model line involving, directly or indirectly, additional investment by any franchisee or the discontinuation or modification of the marketing plan or system of any product or service of the franchisor where the total sales from such product or service exceeds twenty percent of the gross sales of the franchisor on an annual basis.

- An adverse financial development involving the franchisor or the franchisor's parent company, controlling person or guarantor of the franchisor's obligations. In this paragraph, "adverse financial development" includes, but is not limited to: (1) The filing of a petition under federal or state bankruptcy or receivership laws; or (2) A default in payment of principal, interest, or sinking fund installment on indebtedness that exceeds five percent of total assets which is not cured within thirty days of the default.

2. **Guidance From Case Law**

There is very limited case law to assist franchisors in determining when to amend a franchise disclosure document to incorporate material changes. Franchisors (and their counsel) should therefore look to cases involving non-disclosures generally (some of which are discussed in this paper) to assist in this area.

Bixby's Food Systems, Inc. v. McKay, is one of the few cases dealing with materiality in the context of an amendment to a franchise disclosure document. The case began as a trademark infringement action by the franchisor, but the franchisees' counterclaims soon took center stage. Most of the parties settled out, but the president of the franchisor, Mr. Miyamoto, remained a counterclaim defendant. The McKays met Miyamoto in October 1994 as prospective franchisees of the Bixby bagel restaurant concept. At that time, they were given a franchise offering circular ("FOC #1") dated September 6, 1994, which disclosed an estimated initial investment cost between $143,000 and $198,000. The McKays signed a development agreement late in 1994 and began working toward opening their first franchised location. Miyamoto suggested that the McKays build a much larger location than the 2,000 square foot space referenced in FOC #1 so that they might achieve gross sales of $1 million. The McKays thus signed a lease on a 3,000 square foot space. The larger space added to the McKays' initial expenses, which exceeded $400,000.

On April 11, 1995, the McKays (their first location still under development) attended a reception for existing and prospective Bixby's system franchisees, at which Miyamoto spoke. He touted Bixby's 340 signed development agreements as "a $68 million vote of confidence." In reality, though, only 15 agreements had been executed and paid for. The McKays received an amended franchise offering circular ("FOC #2") at the same gathering, and one week later Miyamoto obtained a signed franchise agreement from the McKays for their first location.

The McKays operated their bagel restaurant with poor results for eight months and failed to make their required royalty payments. Bixby's then terminated the franchise agreement and filed suit for trademark infringement. In their counterclaim, the McKays asserted violations of the IFDA based on: (1) the difference in initial expenses disclosed in FOC #1 versus FOC #2; (2) Miyamoto's representation that the McKays' sales would be adequate to cover costs; and (3) Miyamoto's representation that Bixby's had 340 signed and paid development agreements. Surprisingly, neither the financial representations nor the underestimated initial investment costs triggered the Court's ire, but Miyamoto's misrepresentation of the number of signed agreements did.

Materiality never entered into the Court's assessment of the difference in initial expenses between FOC #1 and FOC #2. That inquiry was short-circuited by an expert affidavit, to the effect that a change in the disclosure rules, and not a change in the Bixby's franchise experience, required an amendment to the offering circular to include additional startup expenses, completely explaining the difference. The McKays' claim on that theory therefore failed. Miyamoto's alleged misrepresentation as to the McKays' future earnings likewise did not offend the IFDA. "A statement expressing an opinion or that relates to future or contingent events rather than to present facts . . . 'ordinarily does not constitute an actionable misrepresentation' under Illinois law."

The Court reached a different conclusion as to Miyamoto's "340 development agreements" misrepresentation. A material fact, according to the Court, is "one in which 'a buyer would have acted differently knowing the information, or . . . concerns the type of information upon which a buyer would be expected to rely in making a decision whether to purchase.' In other words, the fact 'must be essential to the transaction between the parties.'" The McKays were able to demonstrate that Miyamoto's untrue statement was material to their investment decision, and the Court granted summary judgment to the McKays based on a violation of the IFDA.

III. MATERIALITY WITHIN THE CONTEXT OF FRANCHISE DISCLOSURE – WHAT TO INCLUDE

A. Guidance from State Examiners: State Risk Factors

State franchise examiners play a role in requiring franchisors to include additional information that they deem to be material to prospective franchisees in franchise disclosure documents. One method of bringing particularly vital information to a prospective franchisee's attention is the state requirement that the franchisor include certain risk factors on the state cover page of the franchise disclosure document. The Amended Franchise Rule does not require franchisors to disclose any required risk factors; however the Franchise Registration and Disclosure Guidelines issued by the North American Securities Administrators Association ("NASAA") require franchisors to include two risk factors. The first requires disclosure of any requirement to litigate, arbitrate or mediate disputes outside of the franchisee's home jurisdiction; the second identifies the choice of law mandated by the franchise agreement. Beyond these two required disclosures, states will often require disclosure of the fact that a franchise program is in its early stages, financial deficiencies in the audited financial statements and large numbers of unit closures. Franchisors may also decide unilaterally to include additional risk factors that they deem material. For example, if a franchise system is heavily reliant on a commodity that is regulated by the Food and Drug Administration and if the franchisor has knowledge that the commodity may be pulled from the marketplace, then a risk factor disclosing this possibility would be appropriate.

Once a state has issued a requirement that a risk factor be included, franchisors must determine whether the risk factor is material in other states. The NASAA Commentary on the FDD Guidelines postulates that a risk factor may very well be material in other states and should be included on the state cover page in those additional states; however, the NASAA noted that state franchise laws have no extraterritorial effect, and the requirements of one state should not automatically be applied to franchise sales efforts in other states. If a franchisor's goal is to have one franchise disclosure document that applies to all the registration states, a franchisor may need to file an amendment in a state so that it may include the risk factor disclosure required by another state.

B. Guidance from the FTC and Case Law

Both the FTC's SBP and case law inform franchisors about which types of information would be material and should be included initially within the franchise disclosure document or, if circumstances arise thereafter, in an amendment thereto.

1. Item 1: The Franchisor, and any Parents, Predecessors, and Affiliates

Item 1 requires franchisors to disclose background information regarding the franchisor and any parents and affiliates. The Amended Franchise Rule also requires three additional disclosures:

> First, franchisors must now disclose information about their predecessors for the 10-year period immediately before the close of the franchisor's most recent fiscal year. This will prevent unscrupulous franchisors from hiding prior misconduct and avoiding disclosure obligations simply by assuming a new corporate identity. Second, franchisors must disclose any regulations specific to the industry in which the franchise business operates, such as any necessary licenses or permits, that may affect the franchisee's operating costs and ability to conduct business. Third, franchisors must describe the general competition prospective franchisees are likely to face. This disclosure better ensures that the prospective franchisee can understand the likely economic risks in purchasing a franchise.

In making decisions about what information may be material under Item 1, franchisors must be mindful of the purpose behind this disclosure—protecting prospective franchisees by attempting to curb creation of new corporate entities simply to hide the background of a company and illuminating the economic risks involved in a concept.

This disclosure becomes particularly important with respect to a franchisor's future business plans. Indeed, during the life cycle of a corporate franchisor, events will transpire that may alter the corporate structure and control of the organization. Most states require an amendment filing to identify a new corporate headquarters or to recognize any modification to the information included in the franchise registration applications. As noted above, Maryland, Minnesota and Hawaii identify corporate structuring issues, such as a change in the name of the franchisor, the state of incorporation or reorganization, as material changes that must be included in an amendment filing.

Mergers, acquisitions, private equity investment and transfers of control may influence a prospective franchisee in its decision making process because the financial condition of the franchisor post-transaction may be impacted by additional debt or reduced cash flow; changes in the officers, directors and management team following the transaction may be of great interest to a prospective franchisee; new affiliated entities and their businesses may impact supply chain issues and corporate resources that would be afforded to the prospective franchisee. In these situations, the franchisor must evaluate the materiality of the event and determine at what stage of the transaction the franchise disclosure document must be amended to notify prospective franchisees.

The decision to amend during the course of a transaction must be weighed against the confidential nature of a transaction. Some franchisors prefer to stop selling franchises during the pendency of the deal so that they may maintain the confidentiality required by the purchaser or investor. Other franchisors may choose to update the franchise disclosure documents in non-registration states and notify potential purchasers in those states of the transaction under the protection of confidentiality agreements.

If a franchise system is being marketed quietly for sale with no transaction underway, there probably is no need for an amendment filing. However if the franchisor signs a letter of intent in conjunction with a sale and is in the process of negotiating deal terms, this event may be viewed as material to a prospective purchaser who may consider the identity of the purchaser as critical to its decision making process. For example, if the purchaser owns competing brands, a prospective franchisee may view the potential franchise sale as less desirable. Most certainly when a binding purchase agreement has been signed, the franchisor must stop franchise sales and amend the franchise disclosure document.

Consider, for instance, Hilton Hotels' position in *Century Pacific, Inc. v. Hilton Hotels Corp.* The case involved Hilton Hotels' former Red Lion chain. During the sales process, Red Lion personnel assured the prospective franchisees that Hilton intended to retain, promote and expand the Red Lion chain, an assurance that the franchisees alleged was critical to their decision to invest. Shortly after that transaction, however, Hilton sold the chain, much to the displeasure of the franchisees. The buyer, WestCoast Hospitality, was "a small, regional hotel chain." Because of its relatively small footprint, WestCoast could not offer the benefits or resources to its franchisees that Hilton could offer. According to the franchisees, the sale by Hilton resulted in decreased bookings, fewer walk-ins and regular clientele, and overall decreased value of the franchise. The franchisees claimed a violation of the New York Franchise Sales Act, common law fraud and negligent misrepresentation. The sellers "knew at the time [of the sales] that Hilton/Doubletree did not intend to retain the Red Lion brand," the franchisees alleged. On a Motion to Dismiss, the Franchise Sales Act claim died, but not the common law claims.

It appeared to the Court in *Century Pacific* that the franchisees had properly alleged a common law fraud claim based on allegations that the defendants "knowingly ma[de] material misrepresentations." The Court seemed to accept the materiality of the alleged misrepresentations based on the franchisees' statements that they relied on the assurances that "[Red Lion] is not for sale." Hilton moved to dismiss, asserting that the oral representations (1) were contradicted by express provisions in the franchise agreements; (2) were negated by the merger clause in the franchise agreement; and (3) amounted to non-actionable "puffing" or "trade talk." As to the first explanation, the Court concluded that the franchise agreement's reservation of rights to Hilton to transfer the Red Lion system said nothing about its present intent at the time of the sale. The merger clause could not rescue Hilton either; under New York law, the Court explained, a merger clause does not bar admission of the oral misrepresentations, nor does it preclude an action for fraud. Finally, the statements could not be ignored as puffing: "if a promise was actually made with a preconceived and undisclosed intention of not performing it, it constitutes a misrepresentation of material existing fact. . . ."

On a similar rationale, the Court in *Century Pacific* refused to dismiss the franchisees' claims for negligent misrepresentation and fraudulent omission. In so doing, the Court rejected Hilton's argument that any duty to disclose arose only in the context of a fiduciary relationship. The Court did not invite any conclusion that the relationship between Hilton and potential franchise buyers was a fiduciary one, but explained that "a *fiduciary* duty is not the sine qua non of fraudulent omissions."

State common law increases a franchisor's non-disclosure risk, adding murkiness in the context of whether and when future changes to aspects of the franchised business must be disclosed. A dynamic franchisor may always be considering changes to its business, eventually jettisoning some ideas and implementing others. In addition to a materiality analysis, the obligation to amend may depend on whether the change is cast in stone. Plans merely under consideration usually need not be disclosed, but as a franchisor's plan matures into imminent implementation, the obligation to disclose may be triggered.

2. Item 2: Business Experience

Item 2 appropriately requires franchisors to disclose the background of those individuals who *control* the franchisor and those who actually *manage* franchisees. That information is material because prospective franchisees need to know the identity and business experience of the individuals in command of the franchisor in order to assess whether these individuals are likely to be able to perform as promised under the franchise agreement.

While the disclosure of the officers and directors of the company is a routine matter with an objective standard, a franchisor must also disclose "any other individual who will have management responsibility relating to the sale or operation of franchises. . ." Franchisors must carefully evaluate their staff and determine which staff will have such responsibility. The matter is critical since the Item 3 litigation and Item 4 bankruptcy disclosures are tied to the individuals disclosed in Item 2. If the franchisor omits a disclosure related to a franchise marketing manager and that manager has been held liable of a fraud offense, that omission would likely be material to a prospective franchisee and may result in a violation of the franchise disclosure laws.

Accordingly, a franchisor must carefully consider who it must initially disclose and when it must disclose changes in its management team. When a franchisor replaces its chief executive officer, is this a material change that necessitates an amendment filing? What if the majority of the members of the board of directors have been replaced? The chief marketing officer or chief development officer? A franchisor facing changes within the management team will need to analyze whether the changes would be material to a prospective franchisee. If a franchisor has a large management team comprised of 25 officers, a change in one member of the team, even the chief executive officer, would arguably not be material. However, if the management team is small and only has 3 members, the replacement of the chief executive officer would more likely affect a prospective franchisee's decision making process.

Additionally, as new personnel join a franchise system, it is imperative that the franchisor inquire whether the new employee has any litigation or bankruptcy matters related to prior employers or their own personal dealings. The franchisor must evaluate whether any litigation or bankruptcy matters that come to light in such investigations would rise to the level of a material change that would necessitate an amendment to the franchise disclosure document.

3. <u>Item 3: Litigation</u>

Item 3 requires franchisors to disclose material civil actions involving the franchisor and related entities and persons and material settlement terms. "Item 3 incorporates a 'materiality' standard. . . . Indeed, immaterial information, by definition, is unlikely to influence a prospective franchisee's investment decision, while imposing unwarranted costs and unnecessarily lengthening disclosure documents." The Amended Franchise Rule included a new disclosure requirement relating to litigation brought by the franchisor against its franchisees in the prior fiscal year. Again, "materiality is determined from the viewpoint of the reasonable prospective franchisee. Accordingly, any franchisor-initiated litigation that goes to the quality of the franchise relationship being offered for sale is likely to be material. Indeed, the Commission intends the disclosure of franchisor-initiated litigation to be interpreted broadly to cover most suits." This is so because disclosure of franchisor-initiated litigation, such as suits to collect royalty payments, "ensure[s] prospective franchisees have material information about the nature of the franchisor's relationship with its franchisees . . .." Such cases are deemed material because they shed light on problems in the franchise system or the likelihood that the franchisor will resort to litigation against a franchisee.

Obviously a franchisor must disclose pending suits such as those filed by the Federal Trade Commission or United States Department of Justice against a franchisor for violations of the Amended Franchise Rule (or other Commission trade regulation rules) or deceptive or unfair trade practices in violation of Section 5 of the FTC Act, as well as state actions, such as those filed by a state Attorney General. What is less clear is when litigation stops being "ordinary routine litigation incidental to the business" and rises to the level of litigation that is material to a franchisee's investment decision. Is a civil lawsuit by a supplier against a large franchise system with many franchisees material? This analysis may depend on the reason the supplier filed the lawsuit and the size of the amount in controversy. If the amount in controversy is small relative to the franchisor's financial condition, the lawsuit may be viewed as "ordinary routine litigation" that does not require disclosure. On the other hand, litigation with serious allegations that seek large damage awards may be material because of the potential impact on even a large franchise system's financial condition.

While there is no doubt that disclosing all material litigation involving the franchisor is required, failure to disclose such litigation does not automatically provide franchisees who later learn of the omission with a cause of action against the franchisor. In *GNC Franchising, Inc. v. O'Brien*, the Court granted the franchisor's motion for summary judgment on the franchisee's counterclaim of fraudulent inducement based on the franchisor's failure to disclose certain litigation with another franchisee in its offering circular. Although the Court concluded that "the falsity of GNC's 1997 UFOC appears clear" and the franchisee alleged that it relied upon the offering circular in deciding to enter into franchise agreements for one or more of their three locations, the Court determined that the franchisee failed to proffer any evidence that the franchisee had received or relied upon this section of the franchise disclosure document, an element of the franchisee's fraud claim.

While a franchisee may have difficulties substantiating reliance upon an omission related to litigation involving the franchisor, this element is not required for governmental agencies to find a franchisor violated relevant franchise laws. For instance, in *In re Cal. Corps. Comm'r v. Play N Trade Franchise, Inc.*, the California Corporations Commissioner found that the franchisor had failed to make several material disclosures in its franchise disclosure document. Specifically, the Commissioner concluded that the franchisor had failed to disclose a lawsuit filed by its former vice president that alleged, among other things, that the principals of Play N Trade and its affiliate "had structured the corporate entities with the intent to insulate themselves from liability and thereby 'defraud potential creditors'" and "committed blatant violations of franchise laws and tax fraud." The Commissioner concluded: "Any prospective Play N Trade franchisee certainly would be interested in investigating the merits of the claims that the franchisor was undercapitalized and had 'committed blatant violations of franchise laws.'" As such, the Commissioner held that "Play N Trade violated section 31200 by willfully misstating, or omitting to state, material facts or changes when filing its franchise renewal applications with the Commissioner."

4. Item 4: Bankruptcy

Item 4 requires a franchisor to disclose whether the franchisor, any parent, predecessor, affiliate, officer, or general partner of the franchisor, or any other individual who will have management responsibility relating to the sale or operation of franchises filed for or were involved in a bankruptcy proceeding. Specifically, Item 4 bankruptcy disclosures require that the franchisor include the material facts of the case. While this Item initially appears to call for a simple, objective report, confirming all individuals' information has been disclosed and selecting the type of information about the case to disclose may not be so cut and dried. Indeed, the identity of creditors and any allegations they may have levied in the proceeding may be material to a prospective franchisee. Accordingly, a franchisor should carefully consider the substance of the pleadings filed in any bankruptcy proceeding.

Under this item, franchisors have a duty to regularly poll their management team to determine whether any new bankruptcy matters have been filed. The recent recession has fueled a rise in the number of personal bankruptcy filings that need to be disclosed in Item 4. Franchisors are cautioned against hurrying through the annual renewal process without taking the time to have their personnel verify that there are no new bankruptcy matters that the franchisor must disclose. Having each individual who is disclosed in Item 2 sign a disclosure confirmation form or questionnaire each year will help to identify any new bankruptcy and litigation matters.

Likewise, when new personnel are hired, a franchisor must determine whether a bankruptcy matter involving the new employee or her prior employers should be disclosed in an amendment to the franchise disclosure document. Arguably, a personal bankruptcy filing based on the recession or the real estate market would not materially impact a prospective franchisee's decision as to whether to purchase the franchise. However, if the new employee was with three companies that were involved in bankruptcy proceedings in the past, an amendment filing may be warranted.

Under the Amended Franchise Rule, the FTC clarified that any affiliate's bankruptcy proceedings must be disclosed in Item 4. Thus, franchisors also must carefully evaluate the business operations of each of its affiliates to ensure that no new bankruptcy filings are made that would impact the Item 4 disclosure requirements.

5. Items 5 & 6: Initial and Other Fees

Under Item 5, a franchisor must disclose any payments that the franchisee is required to make to the franchisor or its affiliates prior to opening and any conditions under which these fees are refundable. Item 6 requires franchisors to disclose recurring or occasional fees associated with operating a franchise (*e.g.*, royalties, advertising fees, and transfer fees). It is hard to imagine disclosure items more material to a franchisee's decision to invest in a franchise concept than these two. "The Commission notes that Item 5 ensures that a prospective franchisee knows whether fees are uniform and, where they are not, enables the prospect to bargain for a lower rate. Item 5 supplies the prospect with some historical information that can aid in gauging the parameters of the franchisor's willingness to negotiate fees."

Item 6 requirements recognize "that a prospective franchisee's investment is not limited to the initial franchise fee alone. Rather, a franchisee may incur considerable costs in the operation of the business, which will significantly impact upon his or her ability to continue in business and ultimately be successful." Franchisors are cautioned to carefully evaluate their existing business operations and their franchise agreements to fully disclose all fees that their franchisee will be required to pay once they join the franchise system. These fees may include website hosting fees, software license fees, site visit fees and other charges beyond the royalty and advertising expenditures.

In Items 5 and 6 of the franchise disclosure document, franchisors are required to disclose whether they have negotiated changes to the fee structure of the franchise agreement in the past year. But as evident in *Kieland v. Rocky Mountain Chocolate Factory, Inc.*, this does not mean that all variations need to be disclosed. The two franchisee plaintiffs in this case alleged violations of the Minnesota Franchise Act ("MFA") based on the franchisor's failure to disclose that it had a "policy and practice of waiving royalty fees for some franchisees." The franchisor's failure to disclose the policy, one franchisee plaintiff argued, artificially inflated the number of system franchisees, a fact that he deemed material. The Court disagreed. The franchisor had, in fact, waived fees for five of its approximately 300 franchisees, but the Court nevertheless deemed the waiver immaterial and found that disclosure was not required.

In the operation of a franchise system, depending on the economic climate, it would be natural to see an increase in and addition of fees, even during the course of a year. For example, as technology changes become available, a franchisor may develop new software, may create a new social media campaign or may require new customer satisfaction surveys or gift card programs. Franchisors generally will save these fee increases and modifications until the annual franchise disclosure update since they would necessitate a material change amendment if the terms of the agreement were altered during the course of the franchisor's fiscal year. However, if the programs are rolled out mid-year, these material changes must be disclosed in an amendment to the franchise disclosure document.

6. <u>Item 7: Estimated Initial Investment</u>

According to the FTC, Item 7 "is designed to furnish prospective franchisees with material information about the likely expenses faced in the start-up phase of the franchise. Armed with such information, a prospective franchisee will know whether or not he or she has the financial ability to get the franchised outlet operational." However, it is important to note that:

> Item 7 is not intended to capture all expenses made over the life of the franchise, which may vary depending upon such factors as the franchisee's choice of suppliers and the terms he or she negotiates with them. . . . Moreover, prospective franchisees may be able to get more detailed estimates of long-term expenses by speaking directly with existing franchisees in their location, or with trademark-specific franchisee associations.

It would be dangerous to read excess leniency into the FTC's statement, however. The franchisor's twin sins of delayed amendments to Item 7 and failure to distribute the amended disclosures supported the franchisees' claims in *Motor City Bagels, L.L.C. v. The American Bagel Co.*, discussed in greater detail *infra* Section IV.A.3.

7. **Items 8 and 11: Restrictions on Sources of Products and Services and Franchisor's Assistance, Advertising, Computer Systems, and Training**

Item 8 disclosures regarding revenues received from suppliers must include "other material consideration" received by the franchisor based on required purchases and leases by franchisees.

> Section 436.5(h) of the final amended Rule requires franchisors to disclose whether it makes the criteria for approving suppliers available to franchisees. In addition, franchisors must state whether, by contract or practice, the franchisor provides material benefits to franchisees who use designated or approved suppliers (*e.g.*, permitting renewals or additional outlets). Finally, it requires franchisors to disclose the existence of purchasing or distribution cooperatives, and whether the franchisor negotiates purchase agreements with suppliers on behalf of franchisees. These highly material disclosures inform prospective franchisees about critical restrictions on how they will have to operate the franchise, which comprise a vitally important aspect of the franchise relationship.

That a deficient disclosure in this area can create havoc is abundantly evident in the Quizno's litigation saga. Franchisee discontent with the costs and suspected actions by the franchisor to negotiate purchase arrangements for its franchisees for its own benefit erupted into war as franchisee profits declined. *Martrano v. Quizno's Franchise Co.*, was an early but telling battle. The franchisees noted Quizno's disclosure in the FOC that Quizno's negotiated terms for the purchase of services and supplies "for the benefit" of its franchisees. Despite this statement, the franchisees alleged that Quizno's – at the time the franchisees were contemplating the purchase of Quizno's franchises – "had no intent to conduct their service/supply related dealings for the benefit of Quizno's franchisees." Further, the franchisees alleged that, if the disclosure was not intended to convey its facially evident meaning, then Quizno's was obligated to "disabuse the reasonable reader of the predictable misunderstanding."

Certainly, the facts supporting the state-wide class action in the *Martrano* case were not limited to disclosure issues. Quizno's alleged business practices, including pricing to franchisees and required sources, enriched the factual stew. But the adequacy of disclosure was critical to both the Complaint and to Quizno's defense. The Complaint alleged antitrust, RICO and state criminal violations, as well as a wide variety of common law claims. From Quizno's standpoint, though, the adequacy of its disclosure in the FOC was a critical issue. The Court in *Martrano* dismissed the antitrust claims, but RICO, fraud in the inducement, negligent misrepresentation, breach of contract, and breach of the duty of good faith and fair dealing claims survived dismissal.

The "for the benefit of franchisees" disclosure in Quizno's FOC, the franchisor argued in *Martrano*, correctly indicated that "in the Quizno's system . . . the franchisor limits sources of supply to *leverage the buying power of the system as a whole.*" That explanation did not satisfy the Court, which commented, "[a] disclosure that Quizno's would make some profit from 'leverag[ing] the buying power of the system as a whole', *i.e.,* that it would take a piece/percentage of a good deal for all, is not a disclosure that Defendants would, as alleged, impose commercially unreasonable/exploitive costs for supplies and services on its franchisees."

The issue of materiality *per se* was not addressed in the *Martrano* case, but is exemplary of the FTC's observation that "a prospective franchisee is entitled to regard as material each and every statement in a franchise disclosure document."

In *Tubby's #14, Ltd. v. Tubby's Sub Shops, Inc.*, numerous franchisees brought an eleven count complaint against the franchisor, alleging violations of the Michigan Franchise Investment Law ("MFIL") and common law fraud related to the franchisor's omission of material information in the FOC and related documents. Specifically, the franchisees alleged that they were damaged as a result of the franchisor's conscious decision not to disclose its gross markup of products. In an order on cross motions for summary judgment, the Court found that the MFIL did not apply to renewals or extensions of an existing franchise, barring some of the plaintiffs' claims; the four year statute of limitations barred others. However, certain plaintiff franchisees could proceed against the franchisor on their claim that the franchisor failed to disclose a significant markup. In so holding, the Court found that these franchisees could have reasonably relied upon the statements made in the FOC. The Court found unpersuasive the franchisor's apparent argument that the franchisee was under a duty to investigate because the actual markup could have been deduced from other documents. The franchisees also alleged that the franchisor failed to disclose the existence of an affiliate and the amount of revenue derived from that affiliate in Item 8 of the FOC. Despite the franchisor's argument that it had disclosed all information necessary and that, even if it had not done so, there was no misleading or incomplete information that would constitute fraud under the Michigan Act, the Court held:

> there is a genuine issue of material fact whether Tubby's must report (1) the revenue generated from [an affiliate], and (2) the amount of the rebate/kickback that Tubby's received from [the affiliate] in their Item 8 disclosure. While Defendants claim that such disclosure is not required, the rules stated above suggest otherwise. Further, if Tubby's was required to make the disclosure and failed to do so, a genuine issue of material fact exists whether its failure to disclose was fraudulent and therefore a violation of Mich. Comp. Laws section 445.1505.

Similarly, the Court found that the franchisees could prove a set of facts which may entitle them to relief under their fraud claim for a violation of the FTC Act. In this count, the franchisees alleged that the franchisor failed to make the required material disclosures under Item 8 related to the affiliate and the kickback scheme.

Item 11 requires a franchisor to disclose the franchisor's principal assistance and related obligations of both the franchisor and franchisee.

> Item 11 also requires franchisors to explain in detail the franchisor's site selection criteria and the franchisor's training program. . . .[T]his provision also requires franchisors to disclose the extent of any advertising assistance and the operation of local, regional, and national advertising councils or co-ops. These disclosures address a common franchisee complaint, namely, that franchisees do not get the quality or quantity of advertising they pay for.

The FTC also:

> believes that Item 11's computer systems disclosures . . . serve a useful purpose. There is no question that the costs a franchisee must incur to purchase or lease computer and related equipment or software, as well as any continuing

> maintenance or upgrade obligations and their associated costs, comprise information that is material to the prospective franchisee's purchasing decision. Information about whether the franchisor will have access to information stored on the franchisee's computers or electronic cash registers also is material, because such access very likely would be a key component of the relationship between the franchisor and franchisee.

Indeed, the FTC "is convinced that additional disclosures are warranted where they will likely prevent deception about the nature of the franchise relationship a prospective franchisee is deciding to enter." This information "not only will enable prospects to weigh the costs and benefits of purchasing a specific franchise, but will better enable prospects to learn if they will be at a technological disadvantage compared to other franchise systems in the industry."

Changes in operations of a business related to purchasing, rebates, services offered and training programs are likely to occur as a matter of course. The issue is whether such changes are material and warrant an amendment to the FDD. Some prospective franchisees may argue that any changes to these items are vitally important to their decisions to enter into a franchise agreement. For example, if an FDD provided to a prospective franchisee indicates that the franchisor's required training program will last for 14 days and the franchisor later modifies the program to require the franchisee to attend a 6-month training program, the increased time and expense associated with the program would likely qualify as a material change to a prospective franchisee. The franchisor's decision to require a franchisee's day-to-day participation in the business, for instance, was a material change that warranted an amendment to the franchise disclosure document under Illinois law, according to the District Court in *Chicago Premium Yogurt, Inc. v. Yogurt Ventures*.

8. <u>Item 19: Financial Performance Representations</u>

Financial performance representations occupy a special place in the FTC's disclosure scheme. Pursuant to the Amended Franchise Rule, on a continuing basis when furnishing a franchise disclosure document to a prospective franchisee, as opposed to a quarterly update addendum, franchise sellers (including brokers) must notify all prospective franchisees of any material changes to information set forth in a financial performance representation about which the franchise seller knows (or should know).

Accordingly, a franchise seller with a fiscal year that is a calendar year who makes a disclosure to a prospect in August must provide any quarterly addendum from the first two quarters and also immediately inform the prospect of any material changes to the Item 19 financial performance representation. By way of example, the FTC Compliance Guide indicates that if new survey results would impact the reliability of the Item 19 presentation, then those results should be brought to the attention of a prospective franchisee. To satisfy the notification requirement, the franchise seller does not have to prepare a written addendum to the franchise disclosure document. Instead, the information can be provided in any reasonable manner including in person, by phone calls and through correspondence. Since the franchise seller has the burden of proving that the required notification was made, written correspondence or an addendum is the preferred course of notifying a prospect. In light of this continuing obligation, franchisors are encouraged to closely monitor the data underlying their financial performance representations and to implement procedures to keep franchise sellers apprised of any material changes. Although the FTC does not require a formal amendment to the FDD to reflect material changes in the Item 19 data, franchisors are required to amend the FDD in the registration states. Accordingly, even though the FTC has implemented a notification system for these types of updates, in reality, franchisors who are engaged in the sale of franchises in the registration states must prepare and file formal amendments to the FDD when there is a material change in this data.

In distinguishing financial performance data from other material changes, which must be disclosed in a quarterly update to the franchise disclosure document, the FTC has described financial data as "particularly material" to prospective franchisees, and indeed materiality is rarely an issue when financial disclosures are attacked. For instance, as discussed more completely above, the franchisor's failure to disclose adverse financial facts about its parent company, despite any requirement that it do so in the Amended Franchise Rule, supported the franchisees' claims in *Colorado Coffee Bean, LLC v. Peaberry Coffee Inc.* In *Dunhill Franchisees Trust v. Dunhill Staffing Systems, Inc.*, the franchisor appealed an arbitrator's award to franchisees of the system. The FOC contained an earnings disclaimer, but even the disclaimer could not shield the franchisor from claims that it failed to disclose that a new franchisee had no chance of financial success in the business. In arbitration, the franchisees successfully argued that the franchisor knew that its business model was no longer viable, and should have disclosed that fact to the franchisees before purchase.

The FTC had similar complaints about the franchisor's financial claims in *FTC v. Transnet Wireless Corp.*, characterizing statements of potential earnings and representations regarding the availability of profitable kiosk locations as "material" misrepresentations. "A representation is material," the Court wrote, "if it is of a kind usually relied upon by a reasonably prudent person . . . Express claims, or deliberately made implied claims, used to influence the purchase of a particular product or service are presumed to be material." This is consistent with the observed practice of many courts accepting franchisees' assertions that particular information was important to their decision as evidence of materiality. Lest one conclude that activist courts have expanded the concept of materiality, it is worth recalling the FTC's admonition that "a prospective franchisee is entitled to regard as material each and every statement in a franchise disclosure document."

Litigators have been known to fight over where the substantive fight will actually occur—and sometimes for good reason. The Vermont District Court in *Sherman v. Ben & Jerry's Franchising, Inc.*, came to precisely the opposite conclusion of the arbitrator in *Dunhill* and the FTC in *Transnet Wireless*. There, a former franchisee of a Ben & Jerry's franchise in Virginia alleged, *inter alia*, that the franchisor fraudulently withheld information from Item 19 of the FOC resulting in "reduced sales and revenue relative to their expectations, reasonably formed based on data provided by Ben & Jerry's." The franchisee argued that Ben & Jerry's "intentionally distorted the earnings information provided in the UFOC and extranet in an effort to induce prospective franchisees to open stores destined to fail" and that she would not have signed the Franchise Agreement or opened a Ben & Jerry's store had the franchisor presented correct earnings data. The Court dismissed the franchisee's claim related to Item 19 nondisclosure based in large part on the franchisor's warnings and disclaimers related to expected profits. The Court explained that recovery required the party claiming fraud to have justifiably relied on the statement or conduct of the other party. In this case, the Court found that Ben & Jerry's FOC Item 19 disclosure had extensive warning built-in:

> Plaintiffs were on notice that Ben & Jerry's "did not represent that any franchisee or Scoop Shop can expect to obtain the reported results," "[a]ctual results vary from Scoop Shop to Scoop Shop," "[Ben & Jerry's] cannot estimate the results of any specific Scoop Shop", and "[a] new franchisee's Scoop Shop results are likely to differ from those of established Scoop Shops."

The Court noted that Ben & Jerry's "explicitly 'recommend[ed] that [Plaintiffs] make [their] own independent investigation and evaluation of the potential performance of [their] Scoop Shop.'" Additionally, "Ben & Jerry's offered 'substantiation for the information contained in [the] Item 19 . . . upon reasonable request' . . . and provided Plaintiffs with contact information for over 260 franchisees located across the United States." Finally, and most surprisingly, the Court found that Ben & Jerry's express disclaimer related to profits, requiring franchisees to acknowledge that they had not received any warranty or guarantee as to the potential volume, profits, or success of the business venture "triggered a duty to investigate." Without saying it directly, the Court implied that the franchisee could have contacted the "over 260" franchisees to ascertain the accuracy of the financial claims. Having failed to investigate and in light of the disclaimers and warnings, the Court found that the franchisee's reliance was not justified as a matter of law and dismissed its fraudulent nondisclosure claim.

Although not cast in such terms, the facts in *Dunhill* beg the question as to whether a franchisor may be obligated to amend an earnings disclaimer to reflect negative financial factors. In connection with the FTC's consideration of the 2007 amendments to the Original Franchise Rule, some commentators suggested that financial performance representations should be mandatory, a suggestion that the FTC rejected. While *Dunhill* seems to suggest that a negative financial situation cannot be hidden behind an earnings disclaimer, *Sherman* appears to allow such conduct and even puts a burden on potential franchisees to investigate. This result should be somewhat troubling to franchisee counsel. Indeed, it would seem only logical that the party with greater knowledge (the franchisor) should have a duty to disclose information it has readily available over burdening the uninformed party with a duty to contact past and/or present franchisees—some of whom may be unwilling or unable (if a confidential settlement exists) to talk to the prospective franchisee. Arguably the best advice was expressed in *GNC Franchising, Inc. v. O'Brien*: "[I]n every solicitation of business dealings, the soliciting party owes a duty to refrain from carelessness in its generation of information and representations to others for profit. . . ."

9. <u>Item 20: Number of Units, Franchisee Lists</u>

Through five mandated tables, Item 20 provides extensive information about the composition of the franchise system. Specifically, these tables provide a description of: (1) the total number of outlets in the system for each of the franchisor's last three fiscal years; (2) the number of franchised and company-owned outlets and changes in the number and ownership of outlets located in each state during each of the last three fiscal years; (3) the status of franchisee-owned outlets located in each state for each of the franchisor's last three fiscal years; (4) the status of company-owned outlets located in each state for each of the franchisor's last three fiscal years; and (5) projected new franchised and company-owned outlets for the current year. "The disclosure of contact information for current franchisees prevents fraud by arming prospects with a valuable alternative source of information with which to verify franchisor's representations."

The number of franchised units would seem to be so entirely objective that little question should arise as to the adequacy of disclosure. Problems can arise, however, when informal statements conflict with reality. *Bixby's Food Systems, Inc. v. McKay*, discussed in greater detail in Section II.C.2 above, is one such instance. During a franchise system meeting that the then-prospective franchisees attended, Bixby's President described the system's 340 signed development agreements as a "$68 million vote of confidence." Only 15 agreements had actually been executed and signed. The prospective franchisees received an amended FOC at that meeting, but no one ever corrected the representation that the system had 340 signed development agreements, a representation that the franchisees testified was important to their decision to invest. As a result, the Court granted the franchisees summary judgment on their Illinois Franchise Disclosure Act claims.

Putting aside blatant misrepresentations related to the composition of the system, changes in the system may occur with far more frequency than with other disclosure items. For instance, a franchisee with multiple stores may close its doors or de-identify and (attempt to) operate independently. Such an occurrence could lead to a material change in the number of units in the system. This change could impact a potential franchisee for a number of reasons, including the loss of income to the franchisor, possible problems or unhappiness with the system that led to the franchisee leaving the system, and the like. As a result, a prospective franchisee would likely view the change in number of outlets as a material change requiring amendment to the FDD.

Franchisors also should consider the state requirements which define a material change based on a number of unit closures, as discussed earlier. Accordingly, franchisors are tasked with monitoring their state and systemwide unit counts to determine when a material change has arisen.

10. Item 21: Financial Statements

A central part of any franchisee's review of a franchise opportunity involves the franchisor's audited financial statements. State regulators review financial statements to determine whether to require franchisors to post additional financial assurances in the form of escrow arrangements, surety bonds, capital infusions, guarantees and fee deferrals. In addition, franchisors with a significant net worth rely on their audited financial statements to take advantage of the large franchisor exemptions that are available in the majority of the registration states.

The issue in *Colorado Coffee Bean, LLC v. Peaberry Coffee Inc.*, was whether the franchisor should have disclosed the financial results of its parent company and some of that company's operations. The parent company owned and operated as many as twenty stores, allegedly unprofitably. The franchisor disclosed the gross sales of the company stores, but failed to disclose net results. The franchisor also omitted any disclosure of separate financial information regarding the parent, which had allegedly been operating at a loss. The franchisees sued for fraudulent non-disclosure. The case was complicated by "inconsistencies in the court's findings and conclusions," necessitating a remand by the appellate court. The Court found no sin in the franchisor's disclosure of only gross, not net, sales by the company stores. The FOC clearly explained that only gross sales were shown, and in conspicuous, clear text, cautioned a prospective franchisee against reliance on those figures as predictors of either the results of any particular franchise, or of the prospective franchisee's particular franchise. In addition, in conspicuous print, the prospective franchisee was admonished to consult with business and legal advisors in connection with the analysis of the financial information provided. In light of these disclosures, potential franchisees could not reasonably have relied on the gross sales figures as predictive of what their franchises might earn, gross or net.

The Court reached a different conclusion regarding the franchisor's failure to disclose its parent company's historic losses. Once again, the testimony of the franchisees was important to the result. Each franchisee had testified that, had he/she known that the franchisor's parent company had longstanding losses, the prospective franchisee would not have invested in the franchise. Parsing a draft decision in the record, the appellate court concluded that the trial court "may have intended to find facts giving rise to [the franchisor's] duty [to disclose]" and further that the financial condition of the parent company was material.

The franchisor in *Coffee Bean* offered two arguments to escape liability, neither of them successful and both worthy of cautionary note by franchisors. First, the franchisor argued that the typical exculpatory clauses in the FOC negated any possibility of reasonable reliance by the potential franchisee. In addition to a merger clause and a disclaimer of reliance on anything other than the contents of the FOC, the franchisor in *Coffee Bean* added a representation by the franchisee that "I am not relying on any promises of PCFI which are not contained in the PCFI Franchise Agreement." None of these provisions, according to the Court, "disclaims reliance on undisclosed but material terms."

Most interesting, perhaps, is the Court's discussion of the Franchise Rule's requirements. The franchisor argued that the Rule neither required nor permitted disclosure of the parent company's financial condition. The Court agreed that the FTC regulations permitted disclosure of a parent company's financial statements only if the parent guaranteed the subsidiary's obligations. However, the Court explained, the Rule did not preclude franchisors from "giving other non-deceptive information orally, visually or in separate literature so long as such information is not contradictory to the information in the disclosure statement." Nor did the Rule "preempt the franchise practices of any state or local government, except to the extent of any inconsistency with [the Franchise Rule]. A law is not inconsistent with this Rule if it affords prospective franchisees equal or greater protection, such as . . . more extensive disclosures." Here, the common law of Colorado, by permitting an action for fraudulent concealment, was not inconsistent with the Franchise Rule. The Court concluded that the "allegedly fraudulent nondisclosure of the parent company's losses is not protected by the FTC regulations."

When a material change impacts financial statements, franchisors must amend their FDDs to include at least unaudited financial statements demonstrating the change in circumstances and they must evaluate whether they have lost the right to claim any large franchisor exemption. If they have lost an exemption, franchisors must file initial registration applications with the registration states and wait for formal review and approval of their franchise offerings before they can continue to sell franchises in these states. Likewise, a bankruptcy or receivership would qualify as a material change necessitating an amendment to the FDD to disclose the situation to prospective franchisees.

IV. DEALING WITH MATERIAL CHANGES – WHEN TO AMEND

A. <u>Federal Requirements</u>

1. <u>Annual Updating Requirement</u>

Every year franchisors must update the information in their franchise disclosure documents within 120 days after their fiscal year end. Most franchisors are familiar with this process and use this opportunity to review each of their disclosure items to ensure that the information is accurate or to update it as necessary. After the 120-day period has expired, franchisors may only use the updated franchise disclosure document and must discontinue the franchise sales process until the updates have been completed.

2. **Quarterly Updating Requirement**

Franchisors also must update their franchise disclosure documents within a "reasonable time after the close of each quarter of the fiscal year to reflect any material change to the disclosures included, or required to be included, in the disclosure document." The quarterly updates may be included in an addendum to the franchise disclosure document, and the franchisor does not need to amend the franchise disclosure document under federal law. Updates can be done more frequently than the Amended Franchise Rule requires at the option of the franchisor or pursuant to the requirement of a state franchise disclosure law. The annual update should include the first quarterly update by either including the information in the franchise disclosure document or by attaching the required addendum.

Franchisors are not required to update certain types of information in their quarterly updates. In particular, franchisor-initiated litigation disclosures in Item 3, statistical information about franchised and company-owned outlets in Item 20, and information regarding franchisee associations in Item 20 need only be revised with the annual updates. Fortunately, franchisors do not need to re-audit any financial information for a quarterly update. If there is a material change that affects the audited financial information that was presented in the franchise disclosure document, franchisors may provide unaudited information in the quarterly update. If unaudited financial statements are included, franchisors need to include a statement reflecting the fact that the information is unaudited.

3. **Rights of Prospective Franchisees to Obtain Updated Disclosures**

The Amended Franchise Rule does not require a franchisor that has already furnished its franchise disclosure document to prospective franchisees to provide any further updated information to those prospects while they are considering their investment in the franchise. Therefore, if a franchisor discloses to a prospect in June and a quarterly update is issued in September and an annual update is prepared in April of the following year, the franchisor has no obligation to disseminate the updated information to the prospect. However, if a prospective franchisee makes a reasonable request before signing a franchise agreement to obtain the most recent annual update or any quarterly update, then the franchisor must provide such disclosure. In the Compliance Guide, the FTC provides an example of a situation where a franchisor has stopped offering franchises for sale and has not updated its franchise disclosure document. In that situation, it would not be considered reasonable for a prospective franchisee to ask for an update because the franchisor was not preparing any updates in its ordinary course of business. In addition, if a franchisor would be in violation of a state registration law if it provided an amendment to the franchise disclosure document prior to the state's acceptance of the amendment application, then the franchisor may withhold the disclosure until the amendment has been accepted. If a franchisor provides an annual or quarterly update to a prospective franchisee, this will not trigger any additional fourteen day disclosure period. Instead a "reasonable time before execution of the agreement will suffice." That being said, as the FTC notes in the Compliance Guide: "It may make good business sense and foster good relations . . . to honor a prospective franchisee's request for more frequent updates, and nothing in the amended Rule would prohibit that."

Despite the foregoing indication in the FTC Compliance Guide that franchisors have no obligation to furnish an update to a prospective franchisee before they purchase the franchise, under the Franchise Rule, it is an unfair and deceptive trade practice to fail to furnish the franchisor's *current* franchise disclosure document at least fourteen days before the prospective franchisee pays a franchise fee or signs the franchise agreement. Accordingly, franchisors are advised to re-disclose their updates to the franchise disclosure document to all prospective franchisees in the pipeline before consummating the sales.

Motor City Bagels, LLC v. American Bagel Co., demonstrates the dangers in failing to properly distribute updated disclosures. The plaintiff franchisees, two MBA entrepreneurs, decided to test their newly-minted degrees by investing in a franchised business. After some investigation, they elected to pursue a Chesapeake Bagel Bakery franchise and received an FOC dated August 23, 1993, from the franchisor. They used the data in that FOC, including the initial cost data, to develop a detailed business plan. Based on that plan, they agreed to a development schedule for several Chesapeake Bagel Bakery restaurants and signed the first franchise agreement on December 3, 1994.

Unknown to the putative franchisees, however, the franchisor had revised its FOC as of April 25, 1994. The revisions included an uptick in the initial investment disclosure. The franchisees denied they received the updated FOC, although the franchisor insisted that it had been provided before the franchisees signed their first agreement. Because the standard on summary judgment requires the court to view the facts in a light most favorable to the non-moving party, the court assumed that the franchisees did not receive the April 25, 1994 updated FOC.

Consistent with their development obligations, the franchisees signed franchise agreements for additional locations on December 27, 1995 and March 6, 1996. As luck would have it, however, the franchisor had once again updated its FOC (as of January 25, 1995), and once again the franchisees denied having ever received the updated information. Just as before, the updated information included another increase in the estimated initial investment. Between the 1993 and the 1995 FOCs, the initial estimated outlay had increased from roughly $244,000 to $400,000.

The franchisees' initial outlays exceeded the 1993 disclosure estimate, and the gulf between the 1993 disclosure estimate and experience increased with each successive restaurant. The business plan became unworkable, the franchisees refused to open any further locations, stopped paying royalties, and sued for violations of the Indiana Franchise Act. Although one section of the Indiana Franchise Act requires scienter and one does not, the Court denied the franchisor's motion for summary judgment on both statutory provisions.

The Court's decision is short on rationale, but implicit in the ruling are conclusions that (1) the franchisor was required to provide the 1994 FOC to the prospective franchisees before they signed their first franchise agreement in December 1994; and (2) the franchisor was required to provide the 1995 updated FOC to the franchisees before they signed their second and third franchise agreements.

The first conclusion appears to honor the admonition in the Franchise Rule that it is an unfair and deceptive practice to fail to furnish the *current* franchise disclosure document at least fourteen days before a prospective franchisee signs the franchise agreement. The franchisor's decision not to provide the 1995 FOC update may have been entirely consistent with the Franchise Rule, if the second and third franchise agreements contained the same terms as the first agreement. The Court did not address that fact. However, even if such were the case, the *Motor City Bagels* case demonstrates that compliance with the Franchise Rule may not satisfy a state statute.

The FTC Franchise Rule Staff made a similar admonition in Informal Staff Advisory Opinion 98-2, which addressed the issue of “whether [under the UFOC format] a franchisor has any obligation to disclose new litigation—and by analogy any other material changes—to a prospective franchisee after the franchisor timely provided the prospective franchisee with a disclosure document that complied with the Rule's quarterly updating requirements.” The short answer turned on whether the franchisor made an earnings representation:

> If the franchisor does not make any earnings representations, then it need not provide a prospect with an addendum setting forth any litigation that may have occurred since the last quarterly update.
>
> On the other hand, if the franchisor makes an earnings representation, then it must update the information found in its earnings claims document (or UFOC Item 19) before the sale is consummated.

The earnings representation would, obviously, only need to be amended if the lawsuit alleged that the franchisor made fraudulent earnings representations. In this case, “the existence of the suit would be highly material to a prospective franchisee who is trying to examine and verify the franchisor's claims.”

The Opinion noted that while “the Rule does not require a franchisor to update its disclosures immediately every time a material change occurs (except where earnings claims are made), nothing in the Rule prohibits a franchisor from doing so. Indeed, such disclosure is clearly within the spirit, if not the exact letter, of the law.” Additionally, the FTC Franchise Rule Staff cautioned that “disclosure may be required under state common law principles of fraud or misrepresentation.”

4. <u>Pre-Sale Negotiation and Material Modification of the Franchise Agreement</u>

As necessitated by the exigencies of the deal and the unique circumstances attributable to a particular franchisee, a franchisor may agree to modify the terms of a franchise agreement. Under the Amended Franchise Rule, modifications that arise out of negotiations between the parties do not trigger any additional disclosure requirements; however, if a franchisor unilaterally and materially modifies the franchise agreement or any other agreement attached to the franchise disclosure document during the offer stage, then the franchisor must provide the prospective franchisee with a copy of the revised agreement at least seven days before the prospective franchisee signs the revised agreement. This disclosure obligation prevents fraud by discouraging franchisors from unilaterally substituting provisions of the agreement that materially differ from the version previously reviewed by the prospective franchisee. Franchisors are cautioned that filling in information such as the protected area radius or the required advertising fund contribution would be considered a material modification that would trigger the seven-day hold period unless this information was previously disclosed to the franchisee.

In FTC Staff Advisory Opinion 97-8, the FTC considered whether a franchisor's modification of a franchise agreement to provide for the opening of an additional unit by an existing franchisee would be a material change that would require the franchisor to provide an updated franchise disclosure document to the existing franchisee. The FTC noted that if there were no additional changes in the terms and conditions of the franchise agreement and no change in company policy or business operations, then expansion by an existing franchisee alone would not qualify as a material change to the original franchise agreement. However, a material change in this scenario could arise if the franchisor had modified its company policy regarding expansion by either abandoning a no-expansion policy or formally adopting an expansion policy that was not previously addressed in the franchise agreement. In that situation, disclosure to existing franchisees who add new units and to prospective franchisees would be required.

The FTC has also addressed the issue of whether an amendment to a franchise agreement would qualify as a material change necessitating an updated franchise disclosure document to an existing franchisee. In Informal Staff Advisory Opinion 02-3, the franchisee requested permission to relocate a franchised outlet outside of its existing protected territory. The relocation request was approved by the franchisor who then required the franchisee to sign an addendum to the franchise agreement to reflect the relocation and required the franchisee to purchase the additional territory for $850 and pay a design fee in the amount of $500. Finding that the modification of the franchise agreement was not the "sale of a franchise" under the Franchise Rule, the FTC noted that the relocation under the amended franchise agreement was initiated by the franchisee and did not result in a material change. The FTC further opined that nothing in the Franchise Rule would require a franchisor to furnish an updated franchise disclosure document to franchisees when they sign amendments to an existing agreement as re-disclosure would provide little useful information to existing franchisees and would impose unwarranted compliance costs on franchisors.

5. Renewal of Franchise Agreements

The Franchise Rule's disclosure obligations are not triggered on renewal of a franchise agreement, and there is no new franchise sale "where there has been no interruption in the franchisee's operation of the business, unless the new agreement contains terms and conditions that differ materially from the original agreement." If a renewing franchisee will sign an extension of its existing franchise agreement or sign a new agreement with the same terms and conditions, then a franchisor will not need to provide a franchise disclosure document to this franchisee. However, franchisors who require their renewing franchisees to sign an addendum to their franchise agreement or sign the franchisor's then-current franchise agreement with new royalty rates, territorial restrictions, fees and the like must first provide pre-sale disclosure.

A franchisor that wants to avoid providing a current franchise disclosure document to an existing franchisee who will be signing a new franchise agreement should carefully consider the implications of *Motor City Bagels, LLC v. American Bagel Co.* discussed *supra.* What is strictly required under the Franchise Rule may not insulate a franchisor from future litigation.

B. State Requirements

State disclosure laws require franchisors to amend their franchise disclosure documents during the course of their fiscal year prior to consummating a franchise sale if any material change occurs in the information disclosed. Although such changes under the Franchise Rule would not need to be disclosed on the federal level until the quarterly update, the registration states require amendment filings to be made closer to the material event. For example, (1) in California, Maryland, Michigan, New York, North Dakota, and Rhode Island, a franchisor must "promptly" file an amendment when a material change occurs; (2) in Hawaii, Virginia and Washington, a franchisor must amend upon the occurrence of a material change; and (3) in Minnesota and Wisconsin, a franchisor must amend within 30 days of a material change. Illinois and South Dakota are more closely aligned with the Franchise Rule and require franchisors to prepare and file amendments to the franchise disclosure document after the end of each fiscal quarter to reflect any material changes. In Indiana, a franchisor does not need to file an amendment for a material change unless requested by the state; however, a franchisor can voluntarily amend at any time to reflect any post-effective amendments to the franchise disclosure document. Since the state laws vary in terms of the required timing to file an amendment, franchisors are encouraged to put procedures in place to identify potential material changes and then amend the franchise disclosure document in short order to meet the state requirements to amend "promptly" and "upon the occurrence" of the event.

1. Annual Renewal Requirements

As with the Franchise Rule, the registration states require franchisors to update their franchise disclosure documents every year. Depending on the state, the annual renewal filing must be made within 90 to 120 days following the end of the franchisor's fiscal year or prior to the anniversary of the effective date of the franchise registration. If the state requires the renewal filing based on the anniversary date of the previous year's franchise disclosure document, the state generally mandates that the renewal filing be made within 15 to 30 days before the previous year's registration expires. Upon filing a renewal application, a franchisor must suspend sales activity in most registration states until the state approves the renewal filings. This is not a long period in Illinois, Indiana, Michigan, South Dakota and Wisconsin, as renewal applications are effective upon receipt. In Hawaii, they are effective seven days after receipt. If the renewal application is not filed in a timely fashion, the franchisor's registration will lapse, all sales activity in the state must cease and the franchisor must file an initial franchise registration application with the state.

2. Amendment Filings

During the period when an amendment application is pending in a registration state, franchisors must cease selling franchises in that state until the state has approved the amendment application. If a franchisor previously disclosed a candidate, the candidate must receive the amended franchise disclosure document approved by the registration state before the franchisor may complete the sale. Franchisors are encouraged to re-disclose all pipeline prospects after an amendment cycle to make sure that each prospect has received the proper registered form of the franchise disclosure document.

It is important to understand when each state determines an amendment application is accepted so that franchise sales may continue. For example, in Maryland, an amendment is automatically effective 15 business days after receipt by the state unless the examiner issues an order or requires additional information. If the examiner requests additional information and that information is submitted, then the amendment to the registration will become effective 15 business days after receipt by the state. In Hawaii, the amendment application is effective seven days after receipt by the state. In most registration states, however, the amendment application is not effective until the state examiner has had the opportunity to review the application and officially approves the amendment application. The state examiners generally try to process amendment applications in short order since they recognize the exigency in recommencing franchise sales.

Both California and New York have procedures that franchisors can follow to continue franchise sales efforts during the period when any amendment application is pending. In California, a franchisor may offer to sell a franchise, but not complete the sale, while an amendment application is pending with the state if the prospective franchisee receives a copy of the franchise disclosure document that was filed with the state along with a written statement that (1) the filing has been made but is not effective, (2) the information in the franchise disclosure document and exhibits has not been reviewed by the state, and (3) the franchisor will deliver the effective franchise disclosure document and exhibits to the prospect at least fourteen days prior to execution by the prospective franchisee of a binding agreement or payment of any consideration to the franchisor showing all material changes from the franchise disclosure document previously provided to the prospective franchisee. In New York, a franchisor may continue its franchise sales efforts while its amendment application is pending by notifying the prospective franchisee of the event requiring the amendment to the franchise disclosure document and by providing a copy of the amended franchise disclosure document once it has been accepted by the state. If the sale is consummated during the period when the amendment application is pending, any fees paid by the franchisee must be placed in an escrow account. After the amended franchise disclosure document is registered in New York, the franchisor must supply a copy of the document to the franchisee who then has the right within a ten business day period following disclosure to rescind the franchise agreement and obtain a refund of any funds paid into the escrow account.

3. Renewal of a Franchise Agreement

Consistent with the Franchise Rule, franchisors generally are not required under state franchise registration and disclosure laws to provide an updated franchise disclosure document to an existing franchisee when they renew a franchise agreement unless the agreement contains materially different terms and conditions than the existing franchise agreement.

4. Negotiated Sales and Material Modifications in California

a. Negotiated Sales

Generally, franchisors may negotiate the terms of their franchise agreements without having to notify the state of the negotiated terms and without having to amend their franchise offerings. However, in California, a franchisor who negotiates with a franchisee can either amend its franchise disclosure document to incorporate the material negotiated terms prior to the sale or can rely on an exemption to the registration requirements of the California Franchise Investment Law. Under the negotiated sales exemption, the franchisor must provide a summary description of each material term negotiated with a California franchisee during the prior twelve-month period in an appendix to the franchise disclosure document. The franchisor must have copies of all negotiated terms available for review by the prospect on written request and identify a contact at the franchisor to whom such requests should be directed. On renewal, the franchisor has to certify to the state that it has complied with the negotiated sales exemption. The franchisor also must retain copies of all material negotiated terms for which the exemption is claimed for a period of five years and must make copies available to the state for review. For purposes of this requirement, California defines "material" terms as those that a reasonable franchisee would view as important when negotiating the franchise agreement.

For purposes of this requirement, California defines “material” terms as those that a reasonable franchisee would view as important when negotiating the franchise agreement. In order to take advantage of the exemption, the franchisor must amend the franchise disclosure document to include the negotiated terms appendix and notify prospective California franchisees of the fact that the terms of the franchise agreement have previously been negotiated. If the negotiated changes do not confer additional benefits on the franchisee, the franchisor must file a Notice of Negotiated Sale of Franchise with the state.

b. <u>Material Modifications</u>

Franchisors that amend the terms of a franchise agreement with an existing California franchisee in their system are cautioned to be aware of the California Franchise Investment Law procedures that they must follow to properly disclose the terms of the amendment. In California, a franchisor may not solicit an existing franchisee's agreement to a proposed material modification of an existing franchise without first providing a written disclosure identifying the proposed modification either five business days prior to executing any binding agreement by the franchisee to the modification or by including a statement that the franchisee can rescind the modification within five business days after the execution of the agreement. Accordingly, if a franchisor wants to add a material term to a franchise agreement (*e.g.,* a requirement that the franchisees participate in a national marketing fund), the franchisor must comply with these disclosure periods. Several types of material franchise agreement modifications are exempt from the disclosure period, including modifications that are the resolution of a bona fide dispute with a franchisee (*e.g.* a settlement agreement) or the resolution of a claimed or actual default if the modification is not applied on a franchise systemwide basis. Franchisors are advised as a matter of course to provide amendment documents to their existing franchisees for review at least five days before execution.

In addition to written exemptions, several California Courts have recently affirmed arguments made by franchisors to avoid disclosure of arguably material modifications. In the case of *In re ConocoPhillips Co. Service Station Rent Contract Litig.*, existing dealers claimed that the franchisor failed to provide disclosures required by California statute related to increased rent to be charged. The Court agreed with the franchisor that the increased rent was not a "material modification" within the meaning of the California Corporations Code because the dealers had already agreed to pay defendant rent "as determined in accordance with Conoco's Rent Policy adopted by Conoco, 'in good faith and in the ordinary course of business.'" While the plaintiff-dealers argued that the issue of materiality was a question of fact that could not be summarily decided on a motion to dismiss, the Court agreed with the franchisor that the materiality of the amendment was not at issue because the rental "adjustment" was not a modification to the existing agreement. Because the relevant documents allowed Conoco to amend or modify the rent policy, the Court found that the new rental policy which brought with it increased rent was not a "material modification of an existing franchise" agreement as contemplated by the statute. The Court concluded that neither the prospective nor the existing franchisee "disclosure obligation requires a franchisor to make disclosures to a franchisee when that franchisor has elected to make an adjustment or modification already authorized to in a lease."

V. CONSEQUENCES OF FAILURE TO DISCLOSE OR AMEND – REMEDIES

Civil penalties, injunctive relief and consumer redress are the options provided for violations of the FTC Act. In *United States v. Building Inspector of America, Inc.,* the government sought, and received, all three types. Noting that courts have "broad power" to restrain acts of the same type as those which offended the FTC Act, the Court observed there that permanent injunctive relief nevertheless should be "narrowly tailored." Such relief was warranted, the Court concluded, based on: (a) TBIA management's inability or unwillingness to take seriously its obligation to comply with the law; (b) its "virtually continuous" violation of the franchise regulations; and (c) the lack of any evidence that TBIA had "changed its ways." The Court invited the government to submit a proposed order for permanent injunctive relief.

The FTC Act authorizes a court to impose civil penalties of up to $10,000 per violation, on any *person or corporation* that violates the Franchise Rule with "actual knowledge." Based on the degree of culpability, history of prior conduct, ability to pay and effect of ability to continue to do business, the Court in *The Building Inspector* assessed civil penalties against both TBIA and its executive individually.

The Court in *The Building Inspector* described the facts that the government needed to demonstrate to support its request for consumer redress as follows:

> In order to obtain relief on behalf of a particular class of consumers, the government need not show that every consumer in the class actually relied upon the defendants' misrepresentations to his detriment. Rather the government need only prove that the defendants made material misrepresentations which were of the type that a reasonable and prudent person would rely upon, that the misrepresentations were widely disseminated, and that franchisees purchased the defendants' franchises.

Here again, the government met its burden, although the specific form of redress was not identified.

FTC v. Transnet Wireless Corp. describes a full panoply of governmental remedies. Individual corporate officers were saddled with personal liability; the parties were enjoined from further non-disclosure violations; the defendants were prevented from disclosing personal information about their victims; and $17.2 million in consumer redress funds were provided to a receiver for distribution to consumers.

Similarly, in the *Play N Trade Franchise* case it was established that the franchisor materially modified the terms of its registered franchise offer without first filing an amendment with the California Corporations Commissioner as required by law. Accordingly, the Commissioner determined that the franchisor violated California law by, *inter alia*, "failing to notify the Commissioner in writing of the changes made in the terms of its registered franchise offer because a prospective franchisee would have reasonably considered the new terms material to negotiating a franchise contract." As a result of this and numerous other violations of state law, the Commissioner fined the franchisor in excess of $100,000, ordered the franchisor to pay restitution to every California franchisee in the amount of the full or partial franchise fee collected from each franchisee, revoked the registration of the franchisor and denied the registration application of the franchisor.

Finally, rescission and restitution are common remedies afforded franchisees for misrepresentation or non-disclosure under both federal and state laws. The registration states generally afford statutory rescission remedies, and the common law of most states includes an equitable claim for rescission, in addition to potential actions for damages.

VI. PRACTICAL APPROACHES FOR FRANCHISOR AND FRANCHISEE

A. Monitoring Material Changes and Ensuring Compliance

When in doubt, disclose. Materiality is both subjective and objective. A franchisor cannot know what a particular prospective franchisee may deem critical to his/her decision-making process, and, as demonstrated by the Court's analytical process in *Morris v. International Yogurt Co.* and others, testimony by a franchisee is relevant to materiality.

Amend sooner rather than later. Financial performance representations, recognized as "particularly material" in the SBP, must be continually amended where necessary. But what constitutes a financial performance representation may be debated by a litigious franchisee. As aptly recognized by the FTC: while "the Rule does not require a franchisor to update its disclosures immediately every time a material change occurs (except where earnings claims are made), nothing in the Rule prohibits a franchisor from doing so. Indeed, such disclosure is clearly within the spirit, if not the exact letter, of the law."

Consider suspending sales during events of significant change. Prospective franchisees who discover shortly after investment that the business is changing in some significant way are frequent sources of litigation. *Century Pacific, Inc. v. Hilton Hotels Corp.*, is only one example of this not uncommon phenomenon.

B. <u>Franchisee Vigilance</u>

Study the franchise disclosure document thoroughly. Practitioners commonly hear from franchisees that they didn't read (or just skimmed) the franchise disclosure document or did not seek the advice of a legal or business advisor in connection with their investment decision. Franchisees need to be educated to the importance of the disclosure, and the advisability of receiving legal and business advice before investing.

Read the Franchise Agreement and other contracts carefully. Several Courts have held that the discretion of the franchisor and/or its reservation of rights to amend certain subjects under the franchise agreement forecloses a franchisee from arguing a later change in the relationship constitutes a "material modification" which would otherwise provide the franchisee with new rights. Accordingly, it is important for prospective franchisees to understand exactly what subjects are left open to later unilateral modification by the franchisor.

Ask the franchisor for any updated or supplemental franchise disclosure document before signing. If a prospective franchisee has sought legal assistance, this is something that practitioners can do for their clients.

Talk to past or present franchisees. Whether fair or not, because some Courts have found a duty on the part of the franchisee to investigate, prospective franchisees should attempt to reach out to past or present franchisees to validate statements made by the franchisor. Unfortunately such investigation and interviewing of past franchisees may be hindered by confidentiality provisions within settlement agreements.

File lawsuits timely. While this advice may be obvious, it is nevertheless important to remember. Indeed, a number of lawsuits related to fraudulent omissions or non-disclosures never reached the merits of the case because Courts found that franchisees were out of time to bring such cases (both under common law fraud and violations of state franchise statutes).

Consult professionals. The help that an attorney and accountant can give a prospective franchisee in analyzing the contents of a franchise disclosure document is, to echo a credit card commercial, "priceless."

VII. CONCLUSION

Materiality, like beauty, is often in the eyes of the beholder. There is no doubt about the materiality of some information—indeed, the FTC and registration states characterize financial information as critical. But the materiality of other disclosure data is left to a franchisor's judgment. As those judgments are made, it is wise to consider not only the FTC or state regulators' views, but those of a potential franchisee.

Assessing materiality does not end the issue, however. Decisions about when and how to amend must accompany the materiality assessment. As we have attempted to demonstrate, the ultimate decision is a complex one.

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