Comments on

Proposed NASAA Statement of Policy Regarding the Use of

Franchise Questionnaires and Acknowledgments

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Notice. The following comments reflect the views and opinions of Baker, Donelson, Bearman, Caldwell & Berkowitz, P.C. (the "Firm") only and do not constitute legal advice or any statement that reflects the positions of, or statements by, any client. The Firm reserves the right to express contrary opinions and take opposing positions when circumstances warrant.

The Corporate Finance Section (the "Section") of the Franchise and Business Opportunities Project Group (the "Project Group") of NASAA seeks public comment on a proposed statement of policy (the "Proposal") regarding the use of franchise questionnaires and acknowledgments in franchise offerings. The Firm offers the following comments and suggestions to the Section and the Project Group.

Background. The Firm represents both franchisees and franchisors, in both regulatory/transactional and litigation contexts. The Firm has included a form of questionnaire/acknowledgment (the "Q/A Form") with its standard franchise transactional documentation package for many years. The Firm has advised franchisors about the benefits and detriments of using a Q/A Form and advised franchisees about the risks in signing a Q/A Form at the time of a franchise purchase transaction. On balance, the Firm believes that the use of Q/A Form benefits both the franchisor and the franchisee and serves as a useful checkpoint and process reconciliation document in the franchise selling process.

The Firm's recommendation for using the Q/A Form stems from a number of elements that borrow from other transactional processes and experience. The use of the Q/A Form assures the transaction parties that the parties' mutual understanding of the relevant facts and circumstances supporting their respective decisions to enter into the transaction, execute and deliver the transaction documents, and pay the amounts and other consideration owed at execution has a solid factual foundation. Because the franchise selling process is largely self-regulated and operates under a voluntary compliance concept, the mutually assured understanding of relevant facts is critical to both sides entering into the transaction with full appreciation and knowledge of such facts.

The Q/A Form borrows from standard practices in mergers and acquisition ("M&A") transactions and real estate financing transactions, where the transactional process occurs over a period of time that the transactional parties cannot unilaterally control. In a typical M&A transaction, the parties negotiate and agree to a transaction agreement (the "M&A Agreement") that includes representations and warranties about various factual matters that are germane to both the formation of the contract and the pricing of the consideration. After signing the M&A Agreement, the parties work to satisfy conditions precedent to closing, and the business of the acquired entity experiences its daily changes between signing and closing. The closing occurs when the parties are satisfied that the closing conditions have been fulfilled and the facts underlying the signing of the M&A Agreement haven't changed in ways or to a degree that would cause one party or the other to decide not to complete the M&A transaction. A document called a "bring down certificate" is signed and delivered by each side, indicating that its representations regarding certain facts important to the transaction made in the M&A Agreement either remain true, or have changed only as described in a form of written disclosure delivered by the certificate party to the recipient of the certificate. Each party is thus assured that its knowledge of the facts important to the party's decision to complete the transaction is consistent with the criteria it has established in the certificate.

Likewise, in real estate financing transactions such as leases and lending, lessors and lenders want assurances that the facts supporting their decisions to enter into or proceed with transactions, such as the absence of defaults in leases or the continued effectiveness of governmental permits and permissions necessary for the transaction to proceed, continue to be true at the closing, and were true at the time of binding commitment, with only such changes as are acceptable to the lessor or lender.

The verification of underlying facts assures the parties that the contract into which they intend to enter is not subject to being avoided by either party as a result of mistake, fraud or misapprehension, delivered immediately prior to closing, is a critical element of modern transactional practice. Why should franchising be any different?

Franchise Transactions. Under the Federal Trade Commission Franchise Rule[1] and those state laws governing the offer and sale of franchises,[2] franchisors must deliver a Franchise Disclosure Document in the prescribed form and containing the prescribed information according to a schedule set forth in the Franchise Rule or the state statute, then wait the required number of days before the franchisee signs the franchise contract and pays the fee due at signing. The FTC Franchise Rule includes the prohibition on franchise seller conduct found at 16 CFR §436.9. Violation of the prohibitions can constitute an unfair or deceptive act or practice under Section 5 of the Federal Trade Commission Act,[3] subjecting the franchisor to the FTC's remedies and penalties under the statute, which are considerable but currently offer no private right of action to aggrieved franchisees. State laws governing the offer and sale of franchises, and deceptive trade practice acts commonly known as "Little FTC Acts,"[4] authorize private rights of action, rescission remedies, treble damages and civil penalties for violations of state law, which may be derivative of violating the FTC Franchise Rule. In other words, the same violation of the FTC Franchise Rule may subject the errant franchisor to the FTC's remedies and to the franchisee's remedies under state law. A rational franchisor will seek to manage this risk by taking reasonable steps to assure itself that its conduct comports with applicable law and gives rise to no bona fide cause of action in favor of a franchisee for violating the laws and regulations governing franchise sales.

[1] 16 C.F.R. Part 436 (the "FTC Franchise Rule").
[2] For example, the California Franchise Investment Law, CAL. CORP. CODE §31000 *et. seq.*, MD. CODE ANN., BUS. REG. §14-201 *et seq.*, New York State Franchise Law, N.Y. GEN. BUS. LAW §680 *et. seq.*
[3] 15 U.S.C. §45.
[4] See, e.g., Florida's Deceptive and Unfair Trade Practice Act, FL. STAT., Title 23, Chapter 501 *et. seq.*

Thus, franchisors undertake genuine and substantial efforts to assure the franchise selling process complies with applicable law.

Franchise selling activity is split between in-house sales forces and independent franchise sellers. Commission-based compensation programs for salespersons are common. Smaller franchisors will engage in outsourced franchise sales to brokers or organizations that enable the franchisor to expand its reach in exchange for a share of the initial and on-going franchise fees. Consequently, participants in the franchise selling process recognize that incentives for completing sales transactions are quite strong. More significantly, prospective franchisees request, provide and receive substantial amounts of information with franchisors through the sales force. The information flow is bidirectional. The sales force collects, compiles and organizes information provided by the prospective franchisee to be considered by the franchisor in its determination of whether to sell the desired franchise to the prospect. In either case, the parties at either end of the information pipeline rely on the conduit parties to disseminate accurate and complete information, and in the case of information flowing to the prospective franchisee, information that complies with franchise law and regulations. This process is invariably complex and at best, is sometimes imperfect, and inconsistent.

For purposes of assuring that any agreement to grant a franchise is based on mutuality of intent for contract purposes, alignment of material facts about the transaction understood by the parties, compliance of the selling process with applicable law and accuracy of information shared by the parties with each other, a franchisor must devise, implement and observe a diligence program with appropriate check points. The franchisor and the franchisee are disserved if the transaction has a faulty premise, or if either party relies on information that the other party has not authorized to be disclosed, or if the franchisee believes it is entitled to restitution in the event of buyer's remorse. Notwithstanding the intentions of remedial statutes and administrative efforts to effect recoveries for aggrieved franchisees, an errant franchise sale has adverse impacts on the participants that may be unforeseen, immeasurable and unrecoverable. For these reasons, it behooves all participants in the franchise transactional decision tree to stop a deal that shouldn't happen before it does happen, so the franchisee doesn't invest money, time, energy and human capital into a business that shouldn't exist, and the franchisor doesn't sell a franchise that shouldn't exist.

<u>The Q/A Form</u>. Over time, each franchisor has the ability to assess and refine its franchise selling process to design and install internal controls and institutional checks and balances seeking to reduce or eliminate the risk of a non-compliant sale. For example, review of the Item 23 receipt, testing the timing of receipt against the proposed closing date to assure compliance with the 14-calendar day waiting period, and testing the timing of the definitive agreement delivery date with the proposed closing date to assure compliance with the 7-calendar day waiting period, if applicable, can be accomplished by a franchisor's administrative staff. But these processes are internal and dependent on the records of the franchisor, and do not necessarily confirm the timing of the recipient side of the communications received by the prospective franchisee. More significantly, an administrative information system cannot guarantee that all communication relevant to the transaction has been collected and stored for retrieval and review by the administrative staff before completing the transaction. The widespread use of electronic signatures using services like DocuSign are helpful, but these services may not capture all relevant communications.

So how should a franchisor assess whether there is mutuality of intent with the franchisee in a complex financial transaction like a franchise sale? That principle is a cornerstone of commercial law and has been since the seminal case where a Michigan court voided a sale of a cow that seller and buyer each thought was barren, but which turned out to be fertile.[5] Does the franchisee intend to buy a franchise under a materially false understanding about the franchise? If the franchise sale can be stopped by some means before both parties commit to a course of action, then how should the parties act?

The Q/A Form used by many franchisors elicits the thought and information both parties need to feel comfortable that that premises for the franchise sale are mutual, and as originally intended by the franchisor. It also generally tests whether the franchisee is relying on information, particularly financial performance representations not included in Item 19 of the franchisor's Franchise Disclosure Document, that may have been provided without the franchisor's authorization or knowledge. In the era of remote work forces, fully electronic communication and decentralization administration, when documents are produced and franchise sales transactions take place without personal interaction except over videoconferencing systems (if that), this highly significant checkpoint in the franchise selling process takes on more importance, as the ability to review and inspect tangible paper files and communications has diminished to essentially nothing.

An enlightened policy underpinning of the use of the Q/A Form would be to prevent a an ill-informed franchise prospect from entering into a transaction and investing thousands of hard-earned dollars into an ill-conceived franchise. That is the primary purpose of the Q/A Form. Rather than reserve a cause of action under state law that enriches franchisee lawyers but doesn't necessarily achieve a return of invested capital by the franchisee, wouldn't a better outcome *for the franchisee* be achieved by allowing the franchisor to stop a transaction before closing, and either reset the expectations of the franchisee or decide that such expectations cannot be reset to the realistic level necessary for achieving the policy goal of informing the prospective franchisee with information that a reasonable franchise investor wants to know?

If the prospective franchisee, in its responses to the Q/A Form questions, doesn't identify those disclosures it received outside the FDD on which it relied in making the decision to proceed with the franchise, then one of three logical conclusions follows regarding the decision about buying the franchise: A) the franchisee relied only on the disclosures in the FDD and collateral materials authorized by the franchisor and furnished by a related party/franchise seller; B) the franchisee relied only on the FDD and information obtained from sources other than the franchisor or a related party/franchise seller; or C) the franchisee refused to inform the franchisor about information sources on which it is relying, so the franchisor is unable to confirm whether clause A or clause B applies. The notion that C is applicable to the franchise sale is exactly what the franchisor seeks to avoid with the Q/A Form.

[5] *Sherwood v. Walker*, 33 N.W. 919 (Mich. 1887).

If the proposed NASAA policy change becomes law or a condition to registration in states with franchise registration laws that include state agency review and approval, then franchisors with strict and closely monitored compliance programs will likely be unaffected. Smaller and emerging franchisors with fewer resources to devote to compliance programs and communications monitoring will either avoid these states entirely, to the detriment of the entrepreneurs in the states, or will choose to take avoidable risk and continue to offer and sell franchises without the benefit to franchisor and franchisee of the Q/A Form as a compliance checkpoint in the selling process.

Confusion between Factual Affirmations and Waivers. The Q/A Forms used by franchisors are not uniform, and may be similar in function, but not necessarily in scope. The text of forms typically includes factual affirmations regarding the receipt of the FDD, the timing of payment of fees and signing of contracts relative to delivery of the FDD and the definitive agreements, the absence of financial performance representations outside the FDD, the completeness of the definitive agreement as to the transaction terms and the accuracy of relevant information, the approval by lenders, investors and other interested parties, and the accuracy and completeness of the franchise application and other submissions of the franchisee. Some forms go beyond the factual affirmations and include releases of the franchisor and the franchise sellers covering claims arising from the franchise selling process, the FDD and performance of the franchisor and its affiliates, at a time when the franchisee could not necessarily know whether some form of informational misconduct has occurred, and waivers of statutory and common law rights exist under applicable state law for this exact purpose to assert rescission claims, civil remedies or private rights of action arising from some infirmity in the selling process.

We do not disagree with the language in the Q/A Form currently required as a condition to registration in some states, namely, that the form does not constitute a waiver of any right or remedy available to an aggrieved franchisee under state franchise law. We believe that anti-waiver provisions in applicable state franchise law[6] are sufficient in their current forms. The Q/A Form should be about facts relevant to the franchise sale process. We further observe that the Q/A Form as originally implemented by the originators, was intended to elicit facts from the selling process in ample time to allow the franchisor to take appropriate action and assure the franchisor's procedural standards and safeguards were observed, and not to limit the remedies available to a franchisee.

Comments on Proposed Policy.

Reference	**Proposal**	**Remarks**
A	Import Definitions from 2008 Franchise Registration and Disclosure Guidelines	We agree. Separate definitions are not necessary.
B-1	Include Q/A Form in Item 22 of the FDD	We agree. This form should be included in the FDD so it can be understood by prospective franchisees and counsel.

[6] *See, e.g.,* MD. CODE ANN., BUS. REG. §14-226.

B-2	Include video response inquiry script in FDD Item 22	We agree. There should be no distinction between the document form and an audiovisual recording of the same information. The policy should definitively permit the use of audiovisual recordings on a disclosed basis and require the franchisor to deliver a protected, encrypted copy of the recording to the franchisee immediately after it is made. This aspect may need further refinement to avoid the modification of the recording or prevent the use of deep fake recordings as that technology evolves.
C-1	Prohibits surrender of rights under Federal or state, shifts disclosure burden, use of statement that conflicts with the Policy	While we agree with the principle generally, we think the prohibition on a document that requires a subjective or unreasonable statement by a franchisee has no standards or guidance on reasonableness or what would be prohibited. For example, a statement to be made by a franchisee to the effect that the franchisee understands the fee structure described in Item 6 may violate that vague standard. Also, the purpose of an estoppel in a commercial transaction is to prevent a party from asserting facts at a later time that are different than what the party affirmed were the facts known to the party at the time of the estoppel statement. Estoppels of facts – e.g., I received the FDD on a date more than 14 days before I signed the franchise agreement and paid the initial franchise fee due at signing – should be expressly permitted.
C-2	Prohibits certain statements from the Q/A Form	We object to this prohibition in general, as it would render the Q/A Form essentially meaningless. We do not object to the prohibition of statements g and h. We do not understand what is intended by k, clause 1. The use of tests or quizzes by franchisors to test the knowledge of franchisees about the same issues after delivery of the FDD would serve the same purpose and is not prohibited. Nor is there any allowance for the use of these statements based on the sophistication of the franchisee, or the amount of the initial investment estimated in Item 7 of the FDD, or the relationship to the exemptions available

		under 16 CFR §436.8(5), or corresponding exemptions under state law for large investment franchises or high net worth, sophisticated investor franchisees.
C-3	Form of statement to be included in FDD and Franchise Agreement negating using waivers and non-reliance affirmations	We do not object to clause (i) for the reasons stated above. We do object to clause (ii) as the purpose of the Q/A Form is to assure both franchisor and franchisee that no unauthorized statement forms the basis of the bargain relied upon by the franchisee in entering the franchise relationship. The assurance provided by the Q/A Form leaves ample opportunity for the franchisee to contest the validity of authorized statements and representations that may turn out to be inaccurate, incomplete or materially misstated.

We note that that prohibition against Risk Factor disclosures originated by the franchisor, now included in the 2008 Guidelines, needs to be rethought by the Project Group in light of the stated purpose of this Policy. We commend to the Project Group a careful consideration of Risk Factor disclosure made voluntarily by franchisors. Guidance of the type provided by the Securities and Exchange Commission in the 2020 amendments to Regulation S-K, which allowed for meaningful risk factor communication to investors in a securities prospectus and in public company periodic disclosure documents, could inform prospective franchise investors about risks of owning the franchise that the franchisor could only communicate through the Q/A Form .[7] If the ultimate policy goal of the Project Group is to promote a regulatory regime that produces a fully informed investor with access to reasonable remedies for inaccurate or incomplete information, then robust risk factor disclosure would seem to be worthwhile.

[7] See Release Nos. 33-10825 and 34-89670, File No. S7-11-19; Modernization of Regulation S-K Items 101, 103 and 105.