



Michael H. Seid  
*Managing Director*

94 Mohegan Drive  
West Hartford, CT 06117

860-604-7559

mseid@msaworldwide.com  
www.msaworldwide.com

Vi email: NASAAComments@nasaa.org  
Andrea.Seidt@com.state.oh.us  
dcantone@oag.state.md.us

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Andrea Seidt, Section Chair  
Dale Cantone, Project Group Chair  
The Corporation Finance Section  
The Franchise and Business Opportunities Project Group  
North American Securities Administration Association, Inc.

Re: Request for public comment: Proposed statement of policy regarding the  
use of Franchise Questionnaires and Acknowledgments - December 6, 2021

To The North American Securities Administration Association, Inc.

Buyer and Seller Representations, Warranties and Acknowledgements are an essential part of the due diligence in any purchase/sale or franchise agreement. Their purpose is to avoid future disputes and costly litigation as potential issues can be disclosed to the other party at the most beneficial and appropriate time - prior to the execution of the agreement. Acknowledgements included in a franchisor's Franchise Disclosure Document (FDD) are a mechanism used by franchisors to reduce the instances of mistakes occurring during the franchisee recruitment process and not as what is categorized in the proposal as a method to insulate franchisors when committing fraud.

Franchisors are not party to every discussion between a franchise recruiter or broker with the prospective franchisee. The only party to the licensing transaction that is present at every discussion is the prospective franchisee. To eliminate the ability for a franchisor to learn at the earliest possible time (prior to the execution of the licensing agreement) of issue in the recruitment process will increase the potential of fraud during franchise recruitment, contrary to the opinions contained in the proposal.

Similar to the buyer and seller reps and warranties routinely found in complex business transactions, the purpose of the FDD is to provide information to prospective franchisees and require franchisors to make defined representations about the franchise offering to a prospective franchisee. No such requirements for prospective franchisees is found in the FTC Rule or in any state relationship law. Obtaining what the franchisor determines is necessary for them to enter into a long-term license of their personal property is an essential element in issuing the license. This proposal to substantially limit and effectively eliminate franchisee pre-sale acknowledgements is counter to the generally accepted standards and practices found in other complex transactions and is a restriction that places the franchise system and other franchisees in the system in jeopardy. I also believe it is an improper restriction under the Federal Lanham Act, as it effectively places restrictions on a franchisor's ability to protect its marks by completing a through due diligence of the franchisee candidate.

I do not argue that the licensing of a franchisor's trademarks and franchise system to a franchisee is identical (legally or practically) to the purchase of a business from a seller. While it shares some similar attributes, there are two material differences. The first is that franchisees, except when purchasing an established location from a franchisor, do not purchase any business from the franchisor. The transaction is merely a defined form of a licensing relationship. The second is that in a licensing relationship, the parties have a continuing and generally long-term interdependent relationship that is distinctly different from the separation that generally and rapidly takes place upon the sale of a business.

What both the licensing relationship and a buy/sell relationship share is that both transactions are based on contracts. Representations and acknowledgements from each of the transactors is necessary for each party to complete their due diligence to their own unique satisfaction. The representations required by the transactors, whether in a franchise agreement or a buy/sell agreement, are essential as each party should have the right to receive the information they require to make their decision on the transaction and each should have the right to rely upon the representations of the other party when entering into the transaction. Given the nature, duration, and interdependence of the intended relationship; the indirect impact on other franchisees in the system; and the necessity of franchisees meeting the system's brand promise to consumers, it can be argued that the franchisee's representations and acknowledgements are actually more important than the typical buyer's representations in a buy/sell agreement.

Franchisors also have a duty to protect its marks and intellectual property under the Federal Lanham Act. It is illogical to assume that a franchisor's obligation to protect its intellectual property begins only after the franchise agreement is signed and does not actually begin during the pre-licensing due diligence period when the franchisor is making the decision on who will be providing the branded products and services to consumers. This proposal invades a franchisor's right to determine in a deliberate manner who it issues a license to.

In the proposed restrictions on franchisee representations and acknowledgements, there is a mischaracterization or misunderstanding of the purpose of the acknowledgement that apparently forms the basis and core reasoning for this proposal.

“Franchisors routinely seek to use Questionnaires, Acknowledgments, and other forms of contractually required disclaimers to insulate themselves from potential liability by franchisees alleging fraud or misrepresentations in the offer and sale of a franchise.<sup>1</sup> Some have been successful.”

This is not true in franchising or in any other complex transaction. Representations in any complex transaction are not required as a “defense of liability” or a shield “to insulate themselves {franchisors} from potential liability by franchisees alleging fraud or misrepresentations” as stated in the proposal. Just as with the reps and warranties in a buy/sell agreement, the franchisee's acknowledgements are merely a statement of fact that the other party to the transaction can and is entitled to rely upon when entering into the transaction. In a practical sense, the elimination of the acknowledgements by the franchisee in a separate document will necessarily require their inclusion elsewhere where it is more likely the franchisee will not have the ability to consider each in as clear a setting as generally provided today.

The relationship in franchising is of significant duration and there is continuing interdependency of the parties not generally found in a buy/sell agreement. Therefore, it is difficult to understand why NASAA believes only one party to the licensing transactions (the franchisee) may receive and rely on Representations (as mandated in the FDD) but the other party (the franchisor) should be regulatorily prevented or restricted from receiving the same. Reps and warranties are beneficial because those statements of fact are made at the time of the transaction and when made in writing can serve as a guide to courts and other triers of facts. As noted in the proposal, courts are quite capable in assessing facts in making their determinations, even when acknowledgements are provided. The limitation on information available to assist the court in making its determination cannot be seen as beneficial to either party.

It is interesting that in this proposal, NASAA is effectively asserting an argument that franchisees do not have the requisite capacity to read and execute an acknowledgement at the time they enter into a franchise agreement. However, NASAA believes that franchisees still retain the necessary capability to read and execute a substantially more complex franchise agreement. This argument is illogical. If, in the opinion of NASAA, franchisees are unable to independently enter into an acknowledgement then I would hope NASAA would require all franchisees to be represented by qualified franchise legal counsel before signing a significantly more complex franchise agreement.

NASAA also makes the argument that franchisors are “shifting the compliance burden from franchisors to franchisees” in asking the franchisee to acknowledge whether certain improper actions occurred during the franchisee recruitment process. Based on my extensive experience this is not the intent or the reality.

During the franchisee recruiting process, franchisees are the sole party to the licensing transaction that touch every aspect of the franchisor’s recruiting effort. While a franchisor has the responsibility of maintaining a process that is free from misrepresentation, this proposal would severely impact the franchisor’s ability to gather all relevant information about the recruitment process. In eliminating a vital source of information, NASAA is preventing the franchisor from taking the necessary steps to prevent such acts from happening and, in doing so, facilitates this potentially happening to other franchise candidates in the future. Enabling a franchisor to discover and fix a problem in the franchisee recruitment process is something NASAA should wish to support.

Based on my decades of experience in assisting clients in the development of their franchise recruitment efforts (including acknowledgements), franchisors are not attempting to “defeat claims of fraud or misrepresentation” during the franchise sales process by asking for an acknowledgement from franchise candidates. Rather, franchisors are trying to ensure the integrity of the recruitment process under the law. It is therefore odd that NASAA would prefer an improper practice to continue rather than encouraging franchisees to acknowledge the correctness of the process or disclose a bad act so that the franchisor can prevent it from occurring again.

NASAA also argues that a reason for eliminating franchisee acknowledgments is that franchisees are making an emotional decision when investing in a franchise. I most certainly agree.

“By the time prospective franchisees are presented with a franchise agreement or Questionnaire to sign, many are emotionally and financially invested in completing the transaction.”



Investing in a franchise, as discussed above, has many of the attributes of a purchase, including the emotional connection the buyer has with the brand. Emotions are part of any purchasing decision including major decisions on which home to buy down to the substantially less significant decision of the brand of clothing you wear or the brand of coffee you drink.

“A brand is a person’s gut feeling about a product, service, or company...It’s a person’s gut feeling, because in the end the brand is defined by individuals, not by companies, markets, or the so-called general public. Each person creates his or her own version of it.”<sup>1</sup> In addition to its coffee, Starbucks’ success is based on how you feel about yourself because of the buying experience.<sup>2</sup>

However, an argument that a franchisee’s emotional attachment to a brand makes it impossible for them to make logical investment decisions is without any foundation. Claiming that franchisees are limited or blinded by their emotions, as if they were children, shows a profound disrespect for franchisees as it assumes they are incapable of making rational, objective, and reflective business decisions.

NASAA argues that franchisees routinely make acknowledgements that are not true on the fear that a franchisor will not allow them to become a franchisee if they tell the truth. Other than a limited number of court cases and anecdotal information provided by franchisee advocates, to my knowledge there has never been a study supporting this theory. Given that 88% of franchisees in a survey conducted by Franchise Business Review expressed satisfaction with their franchisors, I would expect any study to show that this assertion by NASAA as a material problem to be false.

However, if a franchisee does make an improper acknowledgement to induce a franchisor to enter into a licensing agreement of significant duration and value, then arguably the franchisee is committing a fraud. Parties to a contract are entitled to rely on representations and acknowledgement as trust is the sine qua non of the franchise relationship. The argument that the potential deceit of a franchisee in not notifying the franchisor of improper actions by its salespersons, brokers or agent should be avoided by restricting franchisors from asking the questions, is absurd as it puts the franchisor and franchising as a whole at risk.

Equally, by eliminating the need for a franchisee to be candid, NASAA is rewarding a franchisee by allowing them at a later date to make claims that an acknowledgement at the time of the transaction would have prevented. The proposal lacks fairness or any business or legal substance if only based on a review of the opinions in the Anti-Waiver Provision cases cited in support of this proposal. This proposal in substance would eliminate a franchisor’s ability to prevent fraud during the franchise recruitment process and in reality increase the possibility for fraud during the recruitment process. NASAA’s role should be to prevent fraud and not create a petri dish for its growth.

NASAA is arguing that franchisees do not rely on or understand the Franchise Disclosure Document and make a seemingly purely emotional decision in selecting a franchise opportunity

“Nobody buys a franchise in a vacuum. They typically do so after being convinced of the attractiveness of the brand, the strength and utility of the franchisor’s system, the support

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<sup>1</sup> The Brand Gap: How to Bridge the Distance between Business Strategy and Design 2<sup>nd</sup> edition, Marty Neumeier

<sup>2</sup> <https://martinroll.com/resources/articles/strategy/secret-starbucks-brand-success/>

they will receive from the franchisor, and the enthusiasm they encountered at Discovery Day. **None of these factors are the result of reading an FDD**" (Emphasis added)

If as NASAA is arguing that a franchisee does not read or cannot understand the FDD or that they do not base their due diligence and evaluation of the franchise offering on the FDD, then by extension, one should be also arguing that we should simply eliminate the FDD in its entirety, as it is unnecessary. NASAA is again asserting in this proposal that franchisees, in general, are incapable of making qualified investment decisions. This notion is of course absurd.

NASAA is advancing a caricature of the franchisee as an uneducated or inexperienced investor, unable to access or afford proper legal advisors to assist them in a structured due diligence, or to provide them guidance in understanding the contractual terms of a franchise offering. This caricature is condescending, unflattering and is not true. It is well past time that this profile of franchisees, frequently used by the franchisee bar, be retired.

It is well recognized that in 2021 well over 50% of all franchises today are owned by franchisees that own multiple franchised locations. A significant portion of these multi-unit franchisees also own multiple units in multiple franchise systems. If it were ever true that franchisees, in the large, were at one time unsophisticated and unable to make qualified investment decisions, including whether or not to enter into a franchise relationship, it is most certainly not true today. Based on my decades of experience in franchising with hundreds of franchised brands, this caricature of franchisees has really never been true for the significant majority of franchisees.

Even if one were to assume, for argument sake, that a de minimis percentage of prospective franchisees might meet NASAA's caricature of the "inept franchisee," even then, the failure of a franchisee to engage qualified business and legal advisors prior to entering into a franchise agreement, as recommended by the FTC and NASAA, would not be an excuse for depriving a franchisor of the critical information they require in making their decision on the selection of any franchisee.

The decision not to read the FDD and franchise agreement, invest in proper legal representation or conduct a supported due diligence is a choice. That choice should not grant rights to one party to the detriment of the other. It is frequently argued by the franchisee bar that a franchisee does read or understand an FDD and that they do not have the necessary financial resources to engage proper legal and business counsel despite the recommendations of all franchise regulators and professionals. If the substance of the argument is that a franchisee should be excused for choosing not to read the FDD and franchise agreement or that they are not sufficiently capitalized prior to entering into a franchise relationship to afford legal counsel, I believe NASAA should consider focusing its time instead on better educating the prospective franchisee or potentially placing limits on undercapitalized prospective franchisees from becoming franchisees. If only based on the claims of the franchisee bar that some franchisees do not understand what they are signing, a franchisor is entitled to know if the franchisee read and understood the terms of the offering they are agreeing to. This is an important and essential part of a franchisor's due diligence.

Even, for the sake of argument, were there a shrinking minority of franchisees that fit the caricature portrayed in NASAA's proposal, there are an abundance of books, articles, and other information available today for prospective franchisees to become educated on acquiring a franchise. Some of this information is published by the FTC and NASAA members for free and is available on variety of

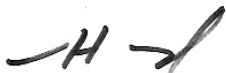
other web sites. Recently the State of California published on its web site an eighty-three (83) page due diligence workbook I authored for prospective franchisees. (<https://dfpi.ca.gov/wp-content/uploads/sites/337/2021/10/Making-the-Franchise-Decision-Workbook-2021.pdf>). In one version or another, this workbook has been posted on my firm's web site, the International Franchise Association's web site, and others for more than a decade.

Surprisingly, many of the acknowledgements NASAA proposes to eliminate are included in information published by federal and state regulators as recommendations and guides to prospective franchisee. For example the Federal Trade Commission publishes "A Guide to Buying a Franchise" <https://www.ftc.gov/tips-advice/business-center/guidance/consumers-guide-buying-franchise> and the State of California publishes "Look before you Leap – A Guide to Buying a Franchise" <https://dfpi.ca.gov/wp-content/uploads/sites/337/forms/Securities/DFPI-SRD-QR-518.pdf>. As provided for in the federal and state publications, the information include in the acknowledgments franchisors seek are a necessary and critical part of the franchising process.

I have reviewed the acknowledgement that NASAA proposes to eliminate and do not believe that NASAA has made the case that eliminating any of the listed disclosures or limiting their purpose strengthens franchising, provides any protection to franchisees, or decreases the potential for claims of purported fraud during the franchise recruitment process. Indeed, based on my extensive experience, the elimination of the included list of acknowledgements and the restrictions proposed will actually weaken franchising and increase the potential for fraud.

I strongly oppose the proposed restrictions on acknowledgements by franchisees as currently proposed.

Respectfully,



Michael Seid  
Managing Director  
MSA Worldwide